AUG 6 1985

Y 4. G 74/7: D 36/21

PROBLEMS IN THE PRICING OF NEGOTIATED DEFENSE CONTRACTS

ORIGINAL

HEARING

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON

GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 3, 1985

Printed for the use of the Committee on Government Operations

U.S. GOVERNMENT PRINTING OFFICE

58-931 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

CDD

COMMITTEE ON GOVERNMENT OPERATIONS

JACK BROOKS, Texas, *Chairman*

DON FUQUA, Florida
JOHN CONYERS, JR., Michigan
CARDISS COLLINS, Illinois
GLENN ENGLISH, Oklahoma
HENRY A. WAXMAN, California
TED WEISS, New York
MIKE SYNAR, Oklahoma
STEPHEN L. NEAL, North Carolina
DOUG BARNARD, JR., Georgia
BARNEY FRANK, Massachusetts
TOM LANTOS, California
ROBERT E. WISE, JR., West Virginia
BARBARA BOXER, California
SANDER M. LEVIN, Michigan
MAJOR R. OWENS, New York
EDOLPHUS TOWNS, New York
JOHN M. SPRATT, JR., South Carolina
JOE KOLTER, Pennsylvania
BEN ERDREICH, Alabama
GERALD D. KLECZKA, Wisconsin
ALBERT G. BUSTAMANTE, Texas
MATTHEW G. MARTINEZ, California

FRANK HORTON, New York
THOMAS N. KINDNESS, Ohio
ROBERT S. WALKER, Pennsylvania
WILLIAM F. CLINGER, JR., Pennsylvania
ALFRED A. (AL) McCANDLESS, California
LARRY E. CRAIG, Idaho
HOWARD C. NIELSON, Utah
JIM SAXTON, New Jersey
PATRICK L. SWINDALL, Georgia
THOMAS D. (TOM) DELAY, Texas
JOSEPH J. DIOGUARDI, New York
JOHN G. ROWLAND, Connecticut
RICHARD K. ARMEY, Texas
JIM LIGHTFOOT, Iowa
JOHN R. MILLER, Washington

WILLIAM M. JONES, *General Counsel*
JOHN E. MOORE, *Staff Administrator*
STEPHEN M. DANIELS, *Minority Staff Director and Counsel*

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

JACK BROOKS, Texas, *Chairman*

DON FUQUA, Florida
HENRY A. WAXMAN, California
STEPHEN L. NEAL, North Carolina
TOM LANTOS, California
JOHN CONYERS, JR., Michigan

FRANK HORTON, New York
JIM SAXTON, New Jersey
JOSEPH J. DIOGUARDI, New York
JOHN G. ROWLAND, Connecticut

RICHARD C. BARNES, *Staff Director*
LESLIE L. MEGYERI, *Professional Staff Member*

CONTENTS

	Page
Hearing held on October 3, 1985	1
Statement of:	
Brooks, Hon. Jack, a Representative in Congress from the State of Texas, and chairman, Legislation and National Security Subcommittee: Opening statement	1
Conahan, Frank, Director, National Security and International Affairs Division, U.S. General Accounting Office, accompanied by Ron Bononi, evaluator, Los Angeles regional office, and David Cooper, group director, National Security and International Affairs Division	5
Vander Schaaf, Derek J., deputy inspector general, U.S. Department of Defense	71
Wade, Dr. James P., Jr., Assistant Secretary of Defense for Acquisition and Logistics, U.S. Department of Defense, accompanied by Jack Kendig, Director of Cost, Pricing, and Finance	151
Letters, statements, etc., submitted for the record by:	
Conahan, Frank, Director, National Security and International Affairs Division, U.S. General Accounting Office:	
Prepared statement	9–40
Submissions to Chairman Brooks' additional questions	45–52
Submissions to Congressman Horton's questions	62–70
Horton, Hon. Frank, a Representative in Congress from the State of New York: Prepared statement	3–4
Vander Schaaf, Derek J., deputy inspector general, U.S. Department of Defense:	
Audit coverage by DCAA for its last 2 management years ended June 30, 1984 and 1985	138
Prepared statement	80–134
Submissions to Chairman Brooks' additional questions	140–144
Submissions to Congressman Horton's questions	145–150
Wade, Dr. James P., Jr., Assistant Secretary of Defense for Acquisition and Logistics, U.S. Department of Defense:	
List of regulations	183
November 3, 1983, memorandum concerning negotiated single source procurements	155–156
Prepared statement	159–177
Submissions to Chairman Brooks' additional questions	178–180
Submissions to Congressman Horton's questions	186–193

PROBLEMS IN THE PRICING OF NEGOTIATED DEFENSE CONTRACTS

THURSDAY, OCTOBER 3, 1985

HOUSE OF REPRESENTATIVES,
LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Jack Brooks (chairman of the subcommittee) presiding.

Present: Representatives Jack Brooks, Stephen L. Neal, Frank Horton, Jim Saxton, Joseph J. DioGuardi, and John G. Rowland.

Subcommittee staff present: Richard C. Barnes, staff director; Leslie L. Megyeri, professional staff member; Linda Shelton, clerk; Mary Alice Oliver, secretary; full committee staff: Stephen M. Daniels, minority staff director and counsel; and Douglas D. Mitchell, minority professional staff, Committee on Government Operations.

Also present: Ray Poskaitis, GAO detailee.

OPENING STATEMENT OF CHAIRMAN BROOKS

Mr. BROOKS. The subcommittee will come to order.

Today the subcommittee resumes its review of procurement practices at the Department of Defense.

Over the past few years, investigations by this and other congressional committees have disclosed widespread patterns of excessive prices which the Defense Department has paid to contractors for spare parts and other military procurements.

This hearing will focus on whether the Government is paying fair and reasonable prices on negotiated defense contracts. We thus will be examining the reasonableness of subcontract costs negotiated within prime contracts, the Defense Department's program for reviewing the reliability of contractors' price estimating systems, and the allowability of overhead costs in contract pricing.

At the present time the vast majority of defense contracts are awarded without any price competition. In 1984, the Department signed some 82 billion dollars' worth of negotiated contracts without price competition. About half that amount is accounted for by subcontract costs.

We will review the results to date of GAO's first comprehensive investigation since 1966 of pricing practices in defense contracting and subcontracting. To carry out this major study which we requested, the General Accounting Office deployed 50 auditors to 10 key defense contractor locations throughout the country, and

during the course of today's hearing we will hear extensive evidence of unconscionable overcharging by defense contractors, and overpayment by the Defense Department procurement managers.

We will identify major contractors who engineer windfall profits by a variety of techniques, such as negotiating lower prices with their subcontractors and charging higher subcontract prices to the Government; failing to disclose to Government contracting officers all the data on which their price estimates are based; and including unallowable overhead charges in their contract prices.

We will also hear what steps the Defense Department is taking to try to get a handle on these problems, and to try to reach a better understanding of what obviously remains to be done.

In addition to the GAO witnesses, we have with us today representatives of the Department of Defense, the inspector general and the Office of the Secretary of Defense.

I recognize the gentleman from New Jersey, Mr. Saxton, Your Honor.

Mr. SAXTON. Thank you, Mr. Chairman.

Mr. Chairman, thank you for calling me "Your Honor." That is the first time that has happened all morning, and I appreciate it.

Mr. BROOKS. It's a bad day.

Mr. SAXTON. He is trying to help me out.

Mr. Chairman, I have a statement from the ranking member, Mr. Horton, which I would like to ask be made part of the record this morning.

Mr. BROOKS. Without objection, so ordered.

[Mr. Horton's prepared statement follows:]

STATEMENT OF THE HONORABLE FRANK HORTON

THANK YOU, MR. CHAIRMAN.

OUR HEARING TODAY CONCERNS A PROBLEM THAT WE HEAR A LOT ABOUT, BUT WHICH THE DEFENSE DEPARTMENT SEEMS SLOW IN DOING SOMETHING ABOUT: OVERPRICING OF DEFENSE CONTRACTS. THE GOVERNMENT DEPENDS ON THE EFFORTS OF CONTRACTING PERSONNEL TO PROTECT THE INTERESTS OF THE TAXPAYERS. WE WILL BE HEARING THIS MORNING ABOUT PROBLEMS WHICH ARE LIMITING THE ABILITY OF THOSE PEOPLE TO STRIKE THE BEST DEAL FOR THE GOVERNMENT AND TO SAFEGUARD THE PUBLIC INTEREST.

THE REASONABLENESS OF CONTRACTS AWARDED WITHOUT COMPETITION IS HARD TO JUDGE, AND THE GOVERNMENT GOES TO CONSIDERABLE EFFORT TO ESTABLISH NEGOTIATION OBJECTIVES THAT MEET GOVERNMENT REQUIREMENTS, WHILE AT THE SAME TIME OFFERING A FAIR RETURN TO COMPETENT CONTRACTORS. IF A PRICE IS AGREED UPON AS A RESULT OF FAIR COMPETITION, IT IS DIFFICULT TO CALL THE OUTCOME "UNREASONABLE." ON THE OTHER HAND, IF A NEGOTIATION HAS NOT BEEN CONDUCTED FAIRLY, THE GOVERNMENT HAS RECOURSE UNDER THE TRUTH-IN-NEGOTIATIONS ACT. STILL ANOTHER PROBLEM EXISTS, HOWEVER, WHEN INFORMATION HAS BEEN PROVIDED, BUT NOT IN A USEFUL FORM AS REQUIRED BY REGULATIONS. THIS OFTEN APPEARS TO BE THE CASE WITH REQUIRED EVALUATIONS OF SUBCONTRACTORS' COST PROPOSALS.

NEGOTIATIONS INVOLVING SUBCONTRACTS POSE A PARTICULAR PROBLEM. WHETHER THE PRECISE TERMS OF SUBCONTRACTS ARE SET BEFORE OR AFTER THE PRIME CONTRACT HAS BEEN SIGNED WITH THE GOVERNMENT, DOD'S ABILITY TO NEGOTIATE THE BEST DEAL WITH THE PRIME IS COMPLICATED BY THE VARIABLES OF CONTRACTOR-SUBCONTRACTOR RELATIONSHIPS. WHEN SUBCONTRACTS ALSO ARE NON-COMPETITIVELY AWARDED, THE GOVERNMENT'S INTERESTS REQUIRE CERTAIN ADDITIONAL PROTECTIONS.

A RANGE OF AUDIT EFFORTS WITHIN DOD ARE DIRECTED TOWARD ASSURING THAT PROTECTIONS ARE IN PLACE AND THAT PRICES BEING PAID ARE FAIR AND JUSTIFIED. THE ACCOMPLISHMENTS OF THE DOD INSPECTOR GENERAL AND THE DEFENSE CONTRACT AUDIT AGENCY ARE BOTH NOTABLE IN THIS REGARD. AND FROM OUTSIDE DOD, THE GENERAL ACCOUNTING OFFICE CERTAINLY PLAYS AN IMPORTANT PART. IT IS IMPORTANT TO RECOGNIZE, HOWEVER, THAT THERE ARE HIGH COSTS TO THE GOVERNMENT FOR MAINTAINING THESE MULTIPLE SAFEGUARDS THAT COMPETITION WOULD OTHERWISE PROVIDE.

MUCH OF WHAT WE WILL BE HEARING TODAY SUGGESTS THE NEED FOR INCREASED GOVERNMENT ACTIVITY IN ASSURING COMPLIANCE WITH REGULATIONS AND THE STATUTES THEY IMPLEMENT. AT THE SAME TIME, I HOPE DOD WILL NOT LOSE SIGHT OF ITS CHARTER, AS SPELLED OUT IN THE COMPETITION IN CONTRACTING ACT AND SUBSEQUENT LAWS, TO INCREASE THE AMOUNT OF COMPETITION IN DEFENSE PROCUREMENT. INCREASED COMPETITION OFFERS THE SUREST PROTECTION AGAINST OVERPRICING, AND IT PROVIDES THE ADDED SAVINGS OF REDUCING THE AMOUNT OF GOVERNMENT OVERHEAD NECESSARY TO REGULATE NON-COMPETITIVE ACQUISITIONS.

Mr. SAXTON. I would also like to say that early this year at one of this subcommittee's first hearings, I remarked that one of the dangers that I foresaw in this fiscal year was that Congress was about to react to pressure from the American people that we spend less money on defense. I believe the reason for that is that the public has watched carefully to see what has happened, and has pointed out to us as Members of Congress very clearly and carefully that they were tired of hearing about wasteful spending in the Department of Defense and other military-related matters. Sure enough, the budget process worked its way through and that is exactly what happened, and it didn't take any great accountant to figure out that that was going to happen early on this year.

I believe today's hearing is one of those points of inquiry that this subcommittee will make as to how we can attempt to rectify, or make suggestions as to how we might rectify, the situation in terms of more efficient use of our taxpayers' dollars in matters related to defense.

So, Mr. Chairman, I look forward with a great deal of interest to what the witnesses have to say today and look forward to taking part in discussions with them.

Thank you.

Mr. BROOKS. Thank you very much.

Our first witness today is Frank Conahan, Director of the National Security and International Affairs Division, U.S. General Accounting Office. He is responsible for planning and executing all of GAO's work relating to defense and international affairs.

He is accompanied by Ron Bononi, an evaluator from GAO's Los Angeles regional office, and David Cooper, a National Security and International Affairs Division group director.

Gentlemen, we are delighted to have you with us. Mr. Conahan, we will accept your prepared statement for the record.

We need to make a first vote and then we will come right back. We will stand in recess until then.

[Recess taken.]

Mr. BROOKS. The subcommittee will reconvene.

I would like to take a minute to introduce an outstanding member of the GAO team whom you new members have not met. He is a real troublemaker, worked for the GAO for many years, and he has been retired and he may be a consultant from time to time, Mr. Art "Slasher" Schoenhaut.

Go ahead, Mr. Conahan.

STATEMENT OF FRANK CONAHAN, DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RON BONONI, EVALUATOR, LOS ANGELES REGIONAL OFFICE, AND DAVID COOPER, GROUP DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

Mr. CONAHAN. Mr. Chairman and members of the subcommittee, we are delighted to be here today.

We do have a rather lengthy statement and because of the complexities involved in the subjects, which, as you noted earlier, we can submit it for the record. I can summarize my statement in something less than 10 minutes and hit the high points.

Our review of subcontracting pricing and DOD's surveillance of contractor cost estimating methods and practices focused on the safeguards DOD employs to protect against inflated contract prices. Our work on overhead cost settlements, Mr. Chairman, expands on the work that we did for this committee on which we presented testimony in the summer of 1984.

Our work identified a number of significant deficiencies that raise concern about whether DOD contracting officers are negotiating fair and reasonable contract prices. While the deficiencies we found cannot be projected to represent all DOD contracting actions, we believe that they are, in themselves, significant and deserve serious consideration.

We believe improvements are needed, particularly regarding subcontract pricing and surveillance of contract cost estimating methods and practices in order for DOD to have greater assurance that contract prices are fair and reasonable.

I would like to discuss each of the areas covered by our review.

Subcontract costs are significant elements to be considered during negotiation of prime contracts, comprising from 40 to 60 percent of prime contract value. We examined 268 subcontractor cost estimates amounting to about $1.5 billion. These subcontract estimates related to 26 prime contracts.

Of the 268 subcontract cost estimates, 168 were priced before prime contract negotiations and 100 were priced afterward. These latter cost estimates are referred to as prospectively priced. For 87

of the 100 cost estimates, prime contractors were able to achieve subcontract price reductions of $42 million below the amounts negotiated in prime contract prices; the other 13 subcontract cost estimates had not been priced at the time of our review.

We believe the price reductions were achieved in large part because DOD contracting officers either did not require contractors to obtain subcontract cost or pricing data, evaluate the data, or provide the evaluation results prior to prime contract negotiation.

Instead, DOD contracting officers used alternative pricing techniques to establish the reasonableness of subcontract estimates included in prime contract prices. In addition to the overpricing because of deficient estimating practices, 10 prime contracts were overpriced by about $7.4 million because prime contractors did not disclose updated and available subcontract pricing information to DOD contractor officers.

In summary, our review of the pricing of major subcontracts disclosed that the safeguards intended to ensure fair and reasonable prime contract prices were not effectively implemented. Of the 100 prospectively priced subcontracts, 20 were competitive and 80 were noncompetitive. For a majority of the 80, prime contractors obtained cost or pricing data from subcontractors prior to prime contract negotiation. However, prime contractors did not obtain such information in about 30 percent of the cases.

In 18 cases, prime contractors exempted subcontractors from submitting data because the estimates were misclassified as competitive. All of the misclassifications noted in our review were at FMC and Martin Marietta.

DOD contracting officers did not obtain prime contractor or Government evaluations of subcontract proposals for 46 of 80 prospective subcontract cost estimates as required by the Federal acquisition regulation. Therefore, contracting officers did not have sound bases for establishing prime contract prices.

As discussed above, in 23 of the cases, evaluations were not done because prospective subcontract costs for pricing data was not obtained. For the 80 prospectively priced subcontracts, prime contractors performed a total of 65 evaluations. However, 39 of these were after the prime contract price negotiation.

Most of the evaluations performed under prime contract negotiations occurred at General Electric, FMC, General Dynamics, and Hercules. The delayed performance of subcontract proposal evaluations provided distinct opportunities for prime contractors to benefit from the negotiation of substantial price reductions with subcontracts.

To illustrate, Hercules Aerospace Co. conducted evaluations on 11 of 13 subcontract price proposals prior to negotiations on 2 Air Force prime contracts. The evaluations were essentially desk reviews of the price proposals and did not involve visits to the subcontractors' plants to validate the cost or pricing data submissions. The evaluations questioned no costs on 9 of the 11 proposals, and only $335,000 on the other 2 proposals, for something less than 1 percent of the proposed subcontract prices.

After the Air Force prime contract prices were negotiated, Hercules performed indepth evaluations of the 13 price proposals at the subcontractors' plants. Evaluations performed by Hercules

questioned about $16.5 million, or 23 percent of the $69.5 million subcontract proposals. Hercules used the evaluation results to negotiate $11.5 million in price reductions below the subcontract estimates negotiated in the prime contract prices.

When the results of prime contractor or Government evaluations of subcontract price proposals are not provided or available, Government contracting officers are faced with using other alternative pricing techniques to compensate for the missing subcontract proposal evaluations.

DOD contracting officers used alternative pricing techniques for assessing the reasonableness of 56 of the 80 prospective subcontract estimates. These alternate pricing techniques reduced the subcontract cost estimates included in prime contract prices; however, these pricing techniques are not adequate substitutes for indepth evaluations of subcontract price proposals.

Prime contractors consistently use the results of such evaluations to negotiate lower prices with subcontractors than DOD contracting officers achieve in prime contract negotiations by using the alternative pricing techniques.

Let me briefly turn to DOD's surveillance of contractor cost estimating methods and practices. Reliable and accurate contractor cost estimates are fundamental to negotiating fair and reasonable contract prices. Deficient estimating practices can and do cause excessively priced contracts.

We just discussed a number of deficient estimating practices in subcontracting pricing that resulted in contract prices higher than warranted. In many of these cases the contractor substantially complied with the Truth in Negotiations Act as far as our review disclosed at this time by providing all factual data available.

The prime contractors' estimating systems, however, did not develop important information bearing on the reasonableness of subcontract estimates. When overpricing is determined to be caused by poor estimating, the Government has no safeguard such as the Truth in Negotiations Act for reducing the contract prices.

DOD regulations require DCAA to establish and manage a regular program for reviewing contractor estimating methods. We reviewed DCAA's surveillance program to determine whether deficiencies in estimating practices were identified and resolved in a timely manner. We did not independently assess the acceptability of contractor estimating systems.

We found that DOD's cost estimating surveillance program suffers from a lack of (1) agreement among contractors, DCAA, and contracting officers about what constitutes an acceptable estimating system; (2) top management emphasis at all levels, including DCAA, for assuring that contractors have adequate systems; and (3) clear direction for resolving deficiencies in the system.

I will briefly discuss contractor overhead costs. In our July 1984 testimony before this subcommittee, I discussed the need to strengthen the criteria governing the allowability of defense contractors' public relations costs. The information I presented during that hearing was based on final overhead cost settlements at 12 contractor locations.

Our work showed that there were numerous instances where DCAA challenged significant amounts of contractor overhead costs

as unallowable, but administrative contracting officers were nevertheless allowing about 50 percent of the costs questioned. At the 12 contractor locations, $31 million in costs challenged were introduced into negotiations. The administrative contracting officers allowed $16.5 million into overhead.

Our recently completed review of overhead settlements at seven contractor locations disclosed that the contracting officers allowed about 57 percent of the costs challenged by DCAA as unallowable.

Your hearings, Mr. Chairman, were the precursor of two later congressional hearings which focused on the need to improve DOD's system to prevent payment of unallowable overhead costs. Because of the congressional concern and extensive publicity, there are now initiatives underway by both the contractors and DOD to improve overhead cost settlements.

We are encouraged by this progress, but most of these initiatives actually remain to be implemented.

That concludes my summary, Mr. Chairman, and we can take your questions.

[Mr. Conahan's prepared statement follows:]

STATEMENT OF

FRANK C. CONAHAN, DIRECTOR

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

UNITED STATES GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the results of GAO's work to date at major defense contractor plants. The work is being performed at the request of this Subcommittee and the Senate Governmental Affairs Committee. Last year we determined that several aspects of Department of Defense (DOD) contracting activities should be evaluated. They relate to

--the reasonableness of subcontract costs negotiated in prime contract prices,

--DOD's surveillance of contractors' cost estimating methods and practices,

--DOD's use of unpriced contracts,

--adequacy of technical reviews of contractors' price proposals, and

--overhead costs.

We have not begun work on technical reviews and have just started evaluating DOD's use of unpriced contracts. My testimony today will cover subcontract pricing, surveillance of contractor estimating systems, and overhead settlements. Our work has been

performed at segments of ten major defense contractors selected from the 50 largest defense contracting firms. The locations we visited are listed in attachment I to this testimony.

Our review of subcontract pricing and DOD's surveillance of contractor cost estimating methods and practices focused on the safeguards DOD employs to protect against inflated contract prices. Our work on overhead cost settlements expands on the testimony I presented to this Subcommittee in July 1984 on public relations costs, and testimony we presented to other committees earlier this year.[1]

SAFEGUARDS FOR PRICING NONCOMPETITIVE CONTRACTS

DOD's goal is to award as many contracts as possible on a competitive basis. However, in fiscal year 1984, DOD awarded about $82 billion in prime contracts without price competition. Because competitive marketplace forces are absent, DOD must rely, to a great extent, on cost estimates developed and submitted by contractors. The extent to which such cost estimates exceed a

---

[1]Statement of Frank C. Conahan, Director, National Security and International Affairs Division, before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, April 23, 1985.

Statement of Paul F. Math, Associate Director, National Security and International Affairs Division, before the Subcommittee on Investigations of the House Committee on Armed Services, May 20, 1985.

reasonable approximation of the ultimate cost of contract performance may give rise to unjustified gains or enrichments at the expense of the government.

Recognizing the government's vulnerability in negotiating noncompetitive contract prices, the Congress passed the Truth-in-Negotiations Act, Public Law 87-653, 10 U.S.C. 2306(f),in 1962. The Act is intended to protect the government against inflated cost estimates and eliminate overpriced contracts. The Act requires contractors to submit cost or pricing data to support certain noncompetitive price proposals, and to certify at the time of prime contract price agreement that the data submitted are accurate, complete, and current. It also provides for price reductions if it is later found that any defective data in proposals have significantly increased contract prices.

In addition, procurement regulations contain a number of controls that are designed to protect the government's interests and provide assurances that subcontract cost estimates included in prime contract prices are fair and reasonable. DOD also requires the Defense Contract Audit Agency (DCAA) to maintain a regular program for reviewing contractors' cost estimating practices in order to increase the reliability of contract proposals.

Our work identified a number of significant deficiencies that raise concern about whether DOD contracting officers are negotiating fair and reasonable contract prices. While the deficiencies we found can not be projected to represent all DOD contracting actions, we believe they are, in themselves, significant, and deserve serious consideration.

We believe improvements are needed, particularly regarding subcontract pricing and surveillance of contractor cost estimating methods and practices, in order for DOD to have greater assurance that contract prices are fair and reasonable.

I will now discuss each of the areas covered in our reviews.

SUBCONTRACT PRICING SAFEGUARDS WERE NOT EFFECTIVELY IMPLEMENTED

Subcontract costs are significant elements to be considered during negotiation of prime contracts--comprising from 40 to 60 percent of prime contract values. Our review included 26 prime contracts totalling about $10.8 billion. We examined 268 subcontract cost estimates amounting to about $1.5 billion. Of these 268 cost estimates, 168 were priced before prime contract negotiations and 100 were priced after prime negotiations. These latter cost estimates are referred to as prospectively priced.

For 87 of the 100 cost estimates, prime contractors were able to achieve subcontract price reductions of $42 million below the amounts negotiated in prime contract prices. The other 13 subcontract cost estimates had not been priced at the time of our review.

We believe the price reductions were achieved in large part because DOD contracting officers either did not require contractors to obtain subcontract cost or pricing data, evaluate the data, or provide the evaluation results prior to prime contract negotiations. Instead, DOD contracting officers used alternative pricing techniques to establish the reasonableness of subcontract estimates included in prime contract prices.

Although prime contractors substantially complied with the provisions of Public Law 87-653, ten prime contracts were overpriced by about $7.4 million because prime contractors did not disclose updated subcontract pricing information to DOD contracting officers. DOD may be entitled to price reductions on these ten contracts under the provisions of Public Law 87-653.

In summary, our review of the pricing of major subcontracts disclosed that the safeguards intended to insure fair and reasonable prime contract prices were not effectively implemented.

Prospective subcontract cost or pricing data not obtained

The Federal Acquisition Regulation (FAR) provides that for prime contractors that are required to submit certified cost or pricing data pursuant to the Truth-in-Negotiations Act, Public Law 87-653, government contracting officers shall require the prime contractors to also obtain and submit prospective subcontract cost or pricing data in support of each subcontract cost estimate that is $1 million or more, or both more than $100,000 and more than 10 percent of the prime contractor's proposed price. The prime contractor is exempted from the requirement to obtain prospective subcontract cost or pricing data if the award is to be made on the basis of adequate price competition, established catalog or market prices, or prices set by law or regulations. This provision has been in the defense procurement regulations since 1970.

Of the 100 prospectively priced subcontracts, 20 were competitive and 80 were noncompetitive. For a majority of the 80 subcontract cost estimates, prime contractors obtained cost or pricing data from subcontractors prior to prime contract negotiations. However, prime contractors did not obtain cost or pricing data for 23 of the 80 subcontract estimates (29 percent). In 18 cases, prime contractors exempted subcontractors from submitting data because the estimates were misclassified as competitive. All of the misclassifications were made by FMC and Martin Marietta.

To illustrate, FMC misclassified 6 noncompetitive subcontract estimates amounting to $23.6 million as competitive. FMC had received only one subcontract price quotation prior to prime contract negotiations, and did not obtain cost or pricing data from the prospective subcontractors. Accordingly, at the time of prime contract price negotiations, the DOD contracting officers had no assurance that the subcontract cost estimates based on single quotations and included in the proposed prime contract prices were fair and reasonable. FMC was able to negotiate about $3.7 million in price reductions with the six subcontractors below the amounts included in prime contract prices.

Contracting officers did not obtain prime contractor or government evaluations of prospective subcontract price proposals

The Federal Acquisition Regulation provides that the prime contractor is responsible for the review and evaluation of prospective subcontract cost or pricing data, and for the submission of the evaluation results to the government contracting officer as part of the prime contractor's cost or pricing data submission. Also, the DOD contracting officer may request a government evaluation of a subcontract proposal under certain conditions, such as when the prime contractor's evaluation is not considered adequate. These provisions have been in the defense procurement regulations since 1972.

DOD contracting officers did not obtain prime contractor or government evaluations of subcontract proposals for 46 of 80 prospective subcontract cost estimates (58 percent). Therefore, contracting officers did not have sound bases for establishing prime contract prices. As discussed earlier, in 23 of the cases, evaluations were not done because prospective subcontract cost or pricing data was not obtained.

For the 80 prospectively priced subcontracts, prime contractors performed a total of 65 evaluations, however, 39 (or 60 percent) of these evaluations were completed after prime contract price negotiations and used by the prime contractors to negotiate lower prices with the subcontractors. Most of the evaluations performed after prime contract negotiations occurred at General Electric, FMC, General Dynamics, and Hercules. The delayed performance of subcontract proposal evaluations provided distinct opportunities for prime contractors to benefit from the negotiation of substantial price reductions with subcontractors.

To illustrate, under the 1982 Bradley Fighting Vehicle contract, a subcontractor proposed to provide a major subsystem to FMC at $189.7 million. FMC reduced the proposed price to $184.2 million in its proposal to the Army. Throughout prime contract negotiations, the Army contracting officer questioned

about the status of the subcontract proposal evaluation. FMC contended that the evaluation had not been completed and therefore was not available. The Army contracting officer further attempted to reserve the subcontract cost estimate for future pricing by including an estimate in the prime contract price subject to a downward adjustment at a later date. When agreement could not be reached, the Army contracting officer negotiated a reduction in the subcontract cost estimate to $173 million in anticipation of the results of subcontract negotiations.

FMC had completed its subcontract proposal evaluation before prime contract negotiations but had not formalized the results in a published report until one day after prime contract negotiations. The FMC evaluation questioned a significant amount of costs proposed by the subcontractor. The FMC evaluation recommended a price range of $158.6 to $163.9 million. FMC was able to use the evaluation results to negotiate the subcontract price at $167.9 million, or about $5.1 million less than the cost estimate included in the prime contract price.

In another example, Hercules Aerospace Company conducted evaluations on 11 of 13 subcontract price proposals prior to negotiations on two Air Force prime contracts. The evaluations were essentially desk reviews of the price proposals and did not involve visits to the subcontractors' plants to validate the cost

or pricing data submissions. The evaluations questioned no costs on 9 of the 11 proposals and only $335,000 on the other two proposals. The questioned costs were less than 1 percent of the proposed subcontract prices.

After the Air Force prime contract prices were negotiated, Hercules performed in-deptn evaluations of the 13 price proposals at the subcontractors' plants. Hercules also obtained direct labor and indirect expense rate recommendations from DCAA on 11 of the subcontract proposals. These rate evaluations were completed after prime contract negotiations on 10 of the proposals, and were therefore of no direct benefit to the Air Force contracting officer in prime contract negotiations. Evaluations performed by Hercules questioned about $16.5 million, or 23 percent of the $69.5 million subcontract proposals. Hercules used the evaluation results to negotiate $11.5 million in price reductions below the subcontract estimates negotiated in the prime contract prices.

The Air Force contracting officer used "decrement" factors[2] and desk reviews by Air Force technical personnel to establish negotiation objectives for the subcontract estimates included in the two prime contracts awarded to Hercules. Had in-depth

---

[2]A "decrement" factor is an estimated percentage price reduction that the prime contractor is expected to achieve in subcontract negotiations.

proposal evaluations and rate recommendations been made before prime contract negotiations and disclosed to the Air Force contracting officer, substantially lower prices should have been negotiated.

We believe that the nondisclosure of prime contractors' evaluation results on subcontract price proposals caused by either nonperformance, delayed performance, or misclassification of noncompetitive subcontract cost estimates constitutes a major weakness in prime contractors' cost estimating systems. I will discuss this condition and other estimating system weaknesses later in this statement.

Government contracting officers used alternative subcontract pricing techniques that were not as effective as subcontract proposal evaluations

When the results of prime contractor or government evaluations of subcontract price proposals are not provided or available, government contracting officers are faced with using "decrement" factors or other alternative pricing techniques to compensate for the missing subcontract proposal evaluations.

DOD contracting officers used alternative pricing techniques for assessing the reasonableness of 56 of the 80 prospective subcontract estimates (70 percent). These alternative pricing techniques reduced the subcontract cost estimates included in prime

contract prices. However, these pricing techniques are not adequate substitutes for in-depth evaluations of subcontract price proposals. Prime contractors consistently used the results of such evaluations to negotiate lower prices with subcontractors than DOD contracting officers achieved in prime contract negotiations by using alternative pricing techniques.

To illustrate, on a prime contract with Hercules the Air Force contracting officer used "decrement" factors to negotiate a $2.9 million reduction applicable to six subcontract cost estimates amounting to $27.9 million. After prime contract negotiations, Hercules was able to negotiate an additional reduction of $2.4 million in subcontract negotiations through the use of proposal evaluation results completed after prime contract negotiations.

Prime contractors generally achieved substantial price reductions in subcontract negotiations--far in excess of the prime contract price reductions

When subcontract prices are negotiated after fixed-price prime contract awards, contractors have considerable financial incentives to negotiate lower prices than those included in the earlier negotiated prime contracts. As a result, there is a reluctance for prime contractors to conduct timely subcontract price proposal evaluations and to disclose the results to the DOD contracting officers.

Prime contractors reduced subcontract prices by about $42 million (5.3 percent) below the estimates in the prime contracts for 87 prospective subcontracts. Twenty subcontracts were competitive and 67 were noncompetitive.

About $39.3 of the $42 million price reductions pertained to prospectively priced subcontracts at General Electric, FMC, General Dynamics, and Hercules. As indicated earlier, these four contractors completed evaluations on most subcontract price proposals after prime contract negotiations, and utilized the evaluation results to negotiate price reductions with their subcontractors. Subcontract price negotiations were also influenced by a number of other factors unknown at the time of prime contract negotiations. Therefore, we could not attribute the entire $42 million exclusively to the use of subcontract evaluation results. We believe, however, that the prime contractors used the evaluations to negotiate substantial price reductions with their subcontractors. Had the prime contractors completed these evaluations before prime contract negotiations and disclosed the results to DOD contracting officers, similar reductions in prime contract prices should have been achieved.

The subcontract price reductions benefited the prime contractors exclusively on those subcontracts placed under firm fixed-price contracts. However, DOD also benefited from price

reductions on subcontracts placed under fixed-price incentive contracts. Of the $42 million in subcontract price reductions, prime contract prices will also be reduced by about $16.7 million reflecting the DOD cost sharing ratio under fixed-price incentive contracts. Therefore, the net benefit to the prime contractors is estimated at $25.3 million.

Prime contract prices were increased because contractors did not disclose updated subcontract pricing information to the government

We identified overpricing of about $7.4 million including overhead and profit because prime contractors did not disclose more current subcontract pricing information available prior to prime contract negotiations. Questionable pricing was identified on 30 subcontract cost estimates under 10 of the 26 prime contracts included in our review. Twenty-seven of the cost estimates were overpriced and three were underpriced. The net overpricing constitutes less than 1 percent of the $1.5 billion in subcontract cost estimates included in our review.

In essence, prime contractors substantially complied with the provisions of Public Law 87-653 by disclosing the most recent subcontract price quotations, proposals, option prices, results of subcontract price negotiations, and purchase order prices available prior to prime contract negotiations. For those

subcontract cost estimates that were overstated by $7.4 million in the prime contract prices, we intend to issue separate reports to the respective procuring offices recommending action to reduce the prime contract prices.

To illustrate the overpricing conditions identified during our review, FMC proposed to provide fire extinguisher assemblies under the Bradley Fighting Vehicle contract at $864 a unit. The proposed unit price was based on an April 1983 price quotation from a prospective supplier. The Army contracting officer accepted the proposed price in prime contract negotiations completed on April 5, 1984. FMC received an updated price quotation of $775 a unit from the prospective supplier in January 1984. A second prospective supplier also submitted a price quotation of $595 a unit in January. The second supplier reduced its quoted price to $500 a unit on April 2, 1984. None of the lower price quotations were disclosed to the Army contracting officer. As a result, the contract was overpriced by about $437,000, or $550,000 including overhead and profit. FMC subsequently purchased the fire extinguisher assemblies from the second supplier at $500 a unit.

Another prime contractor, General Dynamics, proposed to provide an antenna assembly under a Standard Missile contract. The item was to be obtained from two suppliers. The weighted

average proposed unit price was $1,935 based on September 1982 price quotations. The suppliers updated their proposed prices in June 1983 at $1,849 and $1,425 a unit. The updated proposals preceded prime contract negotiation which was concluded on July 28, 1983. The lower more current subcontract price proposals, however, were not disclosed to the Navy contracting officer. As a result, the Navy contract was overpriced by about $233,000, or $348,000 including add-on pricing factors and profit. General Dynamics subsequently purchased the antenna assemblies from the two suppliers at $1,622 and $1,325 a unit, respectively.

SURVEILLANCE OF CONTRACTOR COST ESTIMATING METHODS AND PRACTICES

Reliable and accurate contractor cost estimates are fundamental to negotiating fair and reasonable contract prices. Deficient estimating practices can, and do, cause excessively priced contracts. I just finished discussing a number of deficient estimating practices in subcontract pricing that resulted in contract prices higher than warranted. In many of these cases, the contractors substantially complied with the Truth-In-Negotiations Act by providing all factual data available. The prime contractors' estimating systems, however, did not develop important information bearing on the reasonableness of subcontract price estimates. When overpricing is caused by poor estimating, the government has no safeguard, such as P.L. 87-653, for reducing the contract prices.

DOD regulations require DCAA to establish and manage a regular program for reviewing contractor estimating methods. We reviewed DCAA's surveillance program to determine whether deficiencies in estimating practices were identified and resolved in a timely manner. We did not, however, idependently assess the acceptability of contractor estimating systems.

DOD recognizes that sound and reliable estimating is the basis for good contract pricing. In a 1983 memorandum the Deputy Secretary of Defense emphasized to contracting officers that:

> "A key element in the timely negotiation of a fair and reasonable price is to start with a well prepared and well documented contractor proposal. In this regard, we must ensure that contractor estimating systems are formalized and follow good estimating procedures * * **

DOD's surveillance efforts, however, have not achieved that objective. We found that numerous estimating deficiencies remain unresolved. Also, since 1982, DCAA has routinely questioned in its proposal audits about 13 percent of the costs contractors estimated. In the agency's 1984 management year, these questionable costs totaled about $24 billion. Further, we noted cases in which estimating deficiencies contributed to questionable costs.

We believe the cost estimating surveillance program suffers from a lack of:

--agreement among contractors, DCAA, and contracting officers about what constitutes an acceptable estimating system,

--clear direction for resolving deficiencies, and

--top management emphasis at all levels, including DCAA.

Resolution of deficiencies is untimely

We found that DCAA has not uniformly achieved timely resolution of the estimating weaknesses they identify. Nine of the ten locations we visited had unresolved deficiencies when we completed our work. At four locations, deficiencies identified in 1981, or earlier, were still unresolved. Further, in a special study, DCAA identified 72 contractors where significant estimating deficiencies were unresolved at the end of 1984. Deficiencies at 21 contractors had been outstanding for over 2 years.

Achieving prompt resolution of estimating deficiencies is important because the weaknesses the auditors identify can affect significant amounts of proposed costs. For example, at the Boeing Aerospace Company, DCAA determined that the

contractor did not develop cost data to support its estimates of "material growth"--a catch-all factor representing various additions to base material costs. The ACO at this location identified a group of six proposals on which the company had estimated a total of $59.8 million in "material growth" costs. In reviewing these proposals, DCAA allowed some material growth costs in the absence of better data, and questioned about $40 million. Government negotiators ultimately allowed about $18 million of the costs DCAA had questioned.

At Martin Marietta, DCAA determined that the company did not provide adequate data to support estimated costs of design changes in proposed material. The company proposed rates up to 10 percent of material costs, but a study DCAA conducted indicated that the company experienced costs averaging less than 1 percent. On a group of four proposals, the company estimated these costs at about $54.4 million, and in reviewing the proposals, DCAA questioned the estimates in total. Government negotiators ultimately allowed about $43 million in design change costs. One negotiator, who allowed a 5 percent factor for design changes, said that the cost was likely to be incurred even though supporting data was lacking.

Elements of an acceptable cost estimating system are not well defined

Procurement regulations do not precisely define what are acceptable estimating practices. Instead, the regulations only discuss the benefits derived from the use of good estimating practices, the rationale for conducting estimating system reviews, and a few broad categories that the auditor should consider in determining the acceptability of a contractor's estimating system.

Because the regulations are not precise, contracting officers and DCAA must use considerable judgment in deciding what are estimating deficiencies. Often, contractors do not agree with the DCAA's judgment and are reluctant to use estimating methods they believe procurement regulations do not require. Divergent views among contractors, contracting officers, and DCAA regarding what constitutes acceptable estimating methods, we believe, has resulted in deficiencies not being identified and resolved in a timely manner.

For example, the DCAA auditors at General Electric and FMC reported that inadequate subcontract proposal evaluations constituted an estimating deficiency. In contrast, DCAA did not examine this area at General Dynamics in its estimating reviews, although the ACO asked the auditors to review it. During our

subcontract pricing work, we found weaknesses at General Dynamics in the area of subcontract evaluations. We bought this matter to the company's attention. However, at this time action has not been taken to strengthen their policies on providing subcontract cost evaluations to contracting officers. We believe that, had DCAA followed up on the ACO's request, this estimating weakness would have been identified for corrective action earlier.

During the subcontract review, we identified seven prospectively priced noncompetitive subcontracts that General Dynamics had estimated at $44.1 million. Using various other pricing techniques, DOD contracting officers accepted a value of $39.4 million for the seven subcontracts. Using evaluation reports that were not made available to the contracting officer, the company negotiated prices totalling $38 million for the seven subcontracts, or about $1.4 million less than DOD contracting officers accepted.

Responsibility for resolving estimating deficiencies is unclear

Procurement regulations provide that where estimating system deficiencies continue to exist and have an adverse effect on prices, the problem should be brought to the attention of procurement officials at a level necessary to bring about corrective action. However, the regulations do not identify which procurement officials are responsible for resolving estimating

system deficiencies. This regulatory gap has created differences of opinion within DOD agencies as to who is responsible for resolving estimating system deficiencies.

At several of the locations we visited, the resident administrative contracting officer (ACO) had accepted responsibility for resolving estimating deficiencies. But at four locations, ACOs relied on either DCAA or the procuring contracting officers from buying activities to resolve estimating deficiencies. Several ACOs doubted their regulatory authority for resolving deficiencies. Because there is no requirement that an acceptable cost estimating system be a precondition to contract with the government, there is no contractual mechanism available to motivate contractors to correct estimating deficiencies such as withholding payments on existing contracts.

We found that the procuring contracting officers we talked to at the buying activities--those who negotiate and award most major contracts--did not accept this responsibility. Procuring contracting officers are generally more concerned about the final pricing of discrete contract actions and not with systemic pricing practices in prime contractors' plants. Generally, procuring contracting officers believed that the adverse effects of estimating deficiencies are mitigated by the DCAA's review of individual price proposals. We strongly disagree with this

position. Uncorrected deficiencies cause DCAA to spend unnecessary time reviewing inadequately prepared and poorly supported cost proposals. And, more important, costs questioned by DCAA are frequently not upheld in negotiations. Thus, we believe uncorrected estimating system deficiencies can and do result in the negotiation of higher prices.

Contract auditor surveillance activities need improvement

We reviewed DCAA's estimating surveillance activities from July 1981 to June 1985. We found that DCAA devoted varying levels of effort to estimating reviews; generally had not conducted in-depth reviews covering all aspects of contractors' estimating systems since the late 1960s and early 1970s; and, normally did not involve technical personnel as part of the evaluation team.

DCAA relied primarily on reviews of individual price proposals to surface estimating deficiencies. Contract administration officials at some locations questioned the effectiveness of this approach. We likewise question the approach and believe it limits the effectiveness of DOD surveillance activities.

DCAA is reluctant to devote a large amount of resources to estimating system reviews because of competing demands for their time. Recognizing this, DCAA revised its procedures in 1982 to

enable the real-time reporting of estimating deficiencies. Real-time reports are prepared when DCAA identifies an estimating deficiency during price proposal audits. DCAA believed that the real-time reporting of estimating deficiencies coupled with periodic in-depth analyses of estimating practices would improve proposal submissions and correspondingly reduce audit effort.

Most of the reports issued at the locations we visited were real-time reports based on deficiencies identified during proposal audits. Real-time reporting, however, was not "coupled" with in-depth analyses. We found that DCAA was issuing real-time reports instead of conducting in-depth analyses. We believe real-time reporting limits DCAA's ability to comment on the soundness or reliability of the estimating system because the reports deal with isolated instances of problems and do not identify the underlying causes or the dollar impact of the deficiencies.

Real-time reporting also does not provide for involving technical personnel in evaluating contractor estimating practices. Technical participation in estimating surveillance at the locations we visited was generally limited. Technical participation in estimating surveillance can, however, significantly contribute to the auditor's ability to identify inadequate estimating methods. Technical personnel at Martin

Marietta, for example, identified a number of estimating practices they considered unacceptable. One involved the company's practice of estimating supervisory time at 20 percent of manufacturing labor hours for certain proposals without providing support for the factor. Industry standards indicated a 10 percent factor would be more reasonable. Because DCAA did not ask about weaknesses technical personnel identified, they did not surface these problems in their estimating surveillance reports.

DOD managers have recently recognized that more attention needs to be devoted to in-depth estimating reviews. In July 1985, the Defense Logistics Agency's Director for Contract Management instructed the agency's contract administration activities to request formal estimating reviews at locations where formal reviews have not been performed recently. Similarly, DCAA reemphasized in a May 1985 memorandum that the real-time reporting policy did not negate requirements for periodic in-depth analysis of estimating practices.

GAO agrees that more in-depth analysis of contractor estimating practices is needed. Because the program as currently structured has not received the attention and priority needed to provide effective surveillance, we believe the Secretary of Defense should assure that appropriate officials provide the oversight needed to strengthen DCAA's surveillance efforts.

These officials should further assure that a framework for defining acceptable cost estimating methodologies is developed, and that regulatory guidance on roles and responsibilities for resolving estimating deficiencies is clarified.

CONTRACTOR OVERHEAD COSTS

In my July 1984 testimony before this subcommittee, I discussed the need to strengthen the criteria governing the allowability of defense contractors' public relations costs. The information I presented during that hearing was based on final overhead cost settlements at 12 contractor locations. Our work showed there were numerous instances where DCAA challenged significant amounts of contractor overhead costs as unallowable, but ACOs were nevertheless allowing about 50 percent of the costs questioned. At the 12 contractor locations, $31 million of costs challenged by DCAA were introduced into negotiations. ACOs allowed $16.5 million into overhead.

Our recently completed review of overhead settlements at seven contractor locations disclosed that ACOs allowed about 57 percent of the costs challenged by DCAA as unallowable. Of the $17.1 million questioned as unallowable, $9.7 million was allowed. The final overhead settlements at the seven locations were concluded between February 1983 and March 1985. Attachment II provides the details of the overhead settlements at each location.

Regulations regarding allowable overhead costs are not clear

Costs challenged by DCAA are not being upheld in negotiations, in large part, because contractors, contracting officers, and contract auditors have different interpretations regarding what costs are allowable. The differing interpretations, we believe, are caused by ambiguities and loopholes in the procurement regulations which deal with overhead costs.

To illustrate, DCAA at Raytheon questioned $66,000 on the basis that the costs were contributions and donations. Procurement regulations state that "Contributions and donations are unallowable." Our review of the negotiation memoranda and other documents disclosed that the auditors challenged the costs because (1) recipients of the funds were listed by the Internal Revenue Service as charitable organizations, (2) Raytheon's invoice for one expense identified the payment as a "contribution", and (3) some expenses were for developing a public announcement on boating safety. The ACO disagreed with DCAA and allowed $33,000 because he believed some of the costs were reasonable business expenses and had been allowed in prior overhead settlements. Differing interpretations such as this are routine in settling overhead costs. Until the ambiguities and loopholes in existing procurement regulations are removed, such situations will continue.

Actions to improve overhead cost settlements

Your hearings were the precursor of two later congressional hearings which focused on the need to improve DOD's system to prevent payment of unallowable overhead costs. Because of the congressional concern and extensive publicity surrounding overhead cost settlements, there are actions underway, by both contractors and DOD, to improve overhead cost settlements. For example, we observed that several contractors (General Electric, Hercules, and RCA) are making a more concerted effort to screen their overhead costs before submitting final proposals. Some contractors have also withdrawn overhead proposals that had been submitted but not yet settled in order to screen them for questionable overhead costs.

After your hearings last year we made two recommendations to the Secretary of Defense in October 1984 concerning public relations costs. In February 1985 a proposed change to FAR was circulated for comment. The proposed FAR change we reviewed would add coverage on public relations costs to the existing coverage on advertising and define certain public relations activities whose costs are either allowable or unallowable. This change is a positive step and should eliminate much of the confusion concerning these costs. This revision has not yet become effective but, according to DOD officials, it should be promulgated in the FAR shortly.

We recommended also in May 1985 that the Secretary of Defense:

--Amend FAR to state that all costs made specifically unallowable under any FAR section are not made allowable under any other section.

--Direct ACOs to negotiate, settle, and document costs questioned by DCAA on an item-by-item basis.

On September 18, 1985, DOD concurred with our first recommendation and partially concurred with the latter recommendation on the premise that individual cost elements need not be negotiated and settled on an item-by-item basis. According to DOD, each cost element should be discussed and tracked to negotation memoranda. Nevertheless, we continue to believe that our recommendation that the government negotiate and settle costs on an item-by-item basis would contribute significantly to the effectiveness of Cost Accounting Standard 405, "Accounting for Unallowable Costs" and would eliminate many of the same unallowable costs which are proposed each year.

DOD has initiated a number of actions to improve overhead cost settlements. On August 5, 1985, the Deputy Secretary of Defense assigned responsibility for overhead cost settlements to the DCAA. This means overhead cost settlements will be based on

auditor determination procedures yet to be developed rather than being negotiated by administrative contracting officers. In addition, the Defense Council on Integrity and Management Improvement directed that a task force be established to review the procurement regulations covering overhead costs to identify ambiguities and loopholes. The task force is expected to complete its review by December 1985. Based on the results of this effort, changes in the regulations may be made.

GAO is pleased to see contractors and the DOD seeking ways to improve overhead cost settlements. We believe the initiative to eliminate ambiguities and loopholes in procurement regulations is particularly important. The more quickly DOD moves to clarify the regulations, the more quickly differences among contractors, DCAA, and ACOs will be resolved. These initiatives should lead to improvements in the overhead settlement process. However, until specific action is taken and concrete proposals are developed, we will reserve judgment on their effectiveness.

Mr. Chairman, that concludes my statement. I will be pleased to answer any questions you have.

ATTACHMENT I

ATTACHMENT I

CONTRACTOR LOCATIONS VISITED

General Electric Corp.,
Aircraft Engine Business
Group
Evendale, Ohio

Martin Marietta Corp.,
Orlando Aerospace
Orlando, Florida

McDonnell Douglas Corp.,
McDonnell Aircraft
Company
St. Louis, Missouri

Raytheon Company
Missile Systems Division
Bedford, Massachusetts

RCA Corp.,
Government Communications
Systems
Camden, New Jersey

Missile and Surface Radar
Moorestown, New Jersey

The Boeing Company
Boeing Aerospace Company
Seattle, Washington

FMC Corporation
Ordnance Division
Operations
San Jose, California

General Dynamics Corp.,
Pomona Division
Pomona, California

Hercules Inc.,
Hercules Aerospace Co.,
Bacchus Works
Magna, Utah

Texas Instruments
Equipment Group
Dallas, Texas

ATTACHMENT II

ATTACHMENT II

SUMMARY SCHEDULE OF SEVEN CONTRACTORS' OVERHEAD COSTS QUESTIONED BY DCAA AND THEIR RESOLUTION BY ACOs

CONTRACTOR	QUESTIONED BY DCAA & NEGOTIATED BY ACO	RESULTS OF NEGOTIATIONS ALLOWED	RESULTS OF NEGOTIATIONS DISALLOWED	PERCENT ALLOWED
FMC - Ordnance Division Operations	$ 549,810	$ 324,810	$ 225,000	59.1
General Electric - Aircraft Engine Business Group	6,401,726	4,775,375	1,626,851	74.6
Hercules Aerospace Company - Bacchus Works	1,284,318	995,377	288,941	77.5
Martin Marietta Corporation - Orlando Aerospace	1,319,261	728,190	591,071	55.2
RCA - Aerospace and Defense	877,498	292,918	584,580	33.4
Raytheon Company - Executive Offices	2,459,952	1,626,468	833,484	66.1
Texas Instruments - Equipment Group - Corporate Research, Development, and Engineering	4,198,000	1,025,000	3,173,000	24.4
TOTAL	$17,090,565	$9,768,138	$7,322,427	57.1

Mr. BROOKS. Thank you very much.

I have a few questions.

Mr. Conahan, why do administrative contracting officers continue to overrule auditors and reimburse contractors for unallowable costs?

Mr. CONAHAN. Though there are improvements underway, serious ambiguities still exist. These ambiguities cause contractors, DCAA, and contracting officers to have differing interpretations.

When the administrative contracting officer is negotiating with the contractor, the contracting officer simply is unable to put on the table a firm, unambiguous statement of costs that are unallowable. This, then, results in a negotiation between the two parties, something that is referred to in the trade as "a bottomline negotiation," and over the years, the results have been pretty much a 50/50 split of the costs that are under negotiation.

As I mentioned, the Department of Defense has developed proposed regulations concerning public relations costs, which were the subject of the hearings in this room a year ago. And we think that they are good regulations. They are yet to be incorporated into the Federal acquisition regulation. We hope to see that before too long.

Since that time, we have made recommendations beyond public relations. We recommended, for example, that costs determined to be unallowable under one category should not be allowable under another category. We also felt that negotiations should be on an item-by-item basis, rather than on a total or bottomline basis.

DOD has agreed with the first recommendation, but is not in agreement with the second recommendation, and has yet to move on either of those two recommendations.

Mr. BROOKS. Should the DOD seek refunds for the $42 million in windfall profits which you identified as resulting from negotiations with subcontractors?

Mr. CONAHAN. To some extent, the Government may recover some of that windfall. To the extent that it relates to incentive type contracts, the Government could share in whatever savings there is to the prime contractor. However, to the extent that it is not an incentive, but a firm fixed price, that would not necessarily occur.

However, to the extent that it can be shown that these prime contract prices were overstated because of noncurrent, incomplete, or inaccurate information being provided to the contracting officer, the Government could very well have a case to be made against the contractor.

If, on the other hand, that is not the case and the windfall is attributable solely to the estimating practices or deficiencies in the estimating system, then the Government has no recourse, as it has under the Truth in Negotiations Act, for the failure to submit current, accurate, and complete data.

Mr. BROOKS. It seems to me one of the basic problems is that we need a better, more sound, more reliable estimating system, so that the contracting officers do not rely on inadequate information and then have no protection against overcharges or windfall profits.

Mr. CONAHAN. That is correct, Mr. Chairman.

Mr. BROOKS. I think that is terrible.

Mr. CONAHAN. I think good cost estimating systems are key to the corrections that are required in this area.

Mr. BROOKS. Would you describe how a prime contractor, such as FMC Corporation, could benefit by erroneously reporting that their subcontracts were competitively awarded?

Mr. CONAHAN. When the contractor designates that the subcontract has been competitively awarded, the contracting officer wrongfully assumes that the price was determined in the marketplace, and that simply is not the case.

Moreover, once a contract or a subcontract is misclassified as competitive, cost or pricing data are not required to be submitted, and the usual safeguards are not available.

In the case of FMC, because of the misclassification that data were not submitted, and FMC did go out and negotiate a $3.7 million reduction in the subcontract.

Mr. BROOKS. Did we get that money, or did they keep it?

Mr. CONAHAN. If it is attributable solely to the cost-estimating system, we don't have——

Mr. BROOKS. We did not get the money back?

Mr. CONAHAN. We did not get the money back; no, sir.

Mr. BROOKS. Wasn't that nice for FMC? Where do they operate?

Mr. CONAHAN. San Jose.

Mr. BROOKS. San Jose. Things must be wonderful out there. A $3.7 million windfall. You know, some people think that is not a lot of money when compared with today's deficit problems of billions of dollars, but, it adds up.

Would you explain how Hercules Aerospace is getting a $11.5 million windfall profit on two Air Force contracts after the prime contracts had been negotiated with DOD?

Mr. CONAHAN. Here was another case where the prime contractor made limited evaluations of the subcontractors' price proposals before the negotiations with the Government. Following the negotiation of the prime contract, the contractor made indepth analyses of the subcontractor proposals and determined that something on the order of $16.5 million was subject to question.

In its negotiations, then, with the subs, they ended up with a price reduction of the $11.5 million on the bases of their later and better evaluations of the subcontractors' proposals.

Mr. BROOKS. We didn't get that $11 million back either.

Mr. CONAHAN. No, sir.

Mr. BROOKS. We should never agree to a prime contract—any contracting officer should never agree with the prime contractor—until at least the results of the Government audits have been reviewed, when available.

There is no reason to sign off with them until you take a look at what those subcontractors ought to be charging, so you have a good cost evaluation. Otherwise, we are at the mercy of every contractor that you have examined. And it hurts my feelings because I pay taxes, a lot more than I like to pay, I might add.

What has happened to the $5.1 million windfall profit that FMC received by negotiating a reduction in its subcontractor costs on the Bradley Fighting Vehicle contract?

Mr. CONAHAN. Here is a case, Mr. Chairman, where I believe that rather than the cost-estimating system being the sole determi-

nant of the price that was achieved, there may very well have been an instance where available information was not provided to the Government. And that being the case, the Government should have recall over this $5.1 million.

Mr. BROOKS. Have they sued them to recover the $5.1 million?

Mr. CONAHAN. They have not, sir. We've discussed this matter with the contracting officer. He is aware of our position on it, and we intend to communicate with the buying activity directly on this thing.

Mr. BROOKS. Maybe we ought to give the plaintiff lawyers in the country a shot at these cases, just let them sue for the Government and give them 30 percent.

And the Defense Department hasn't sued them yet?

Mr. CONAHAN. No, sir, not in this case.

Mr. BROOKS. What are they doing? Talking to them, seeing if they can give them some more? What is the stage of the negotiations now?

Mr. CONAHAN. Quite frankly, I don't think that there is any between the Government and the contractor on this, but hopefully——

Mr. BROOKS. No what?

Mr. CONAHAN. I don't know of any activity between the Government and the contractor at this point.

Mr. BROOKS. No activity. Well, I don't guess FMC's going to come down here and say they're going to pay them. They haven't volunteered yet, have they?

Mr. CONAHAN. No, sir.

Mr. BROOKS. Do you think they will?

Mr. CONAHAN. No, sir.

Mr. BROOKS. Do you think they'll be competing for more Federal contracts?

Mr. CONAHAN. Yes, sir.

Mr. BROOKS. Do you think if I was in charge of them, I'd let them come in the door?

Mr. CONAHAN. I doubt it, sir.

Mr. BROOKS. Not until they paid that $5.1 million cash. Unbelievable, isn't it?

How did General Dynamics overcharge the Navy for antenna assemblies under the standard missile contract?

Mr. CONAHAN. I think that this is a rather clear case of defective pricing. The contractor had current quotations which they simply did not make available to the Government.

Mr. BROOKS. That's $348,000?

Mr. CONAHAN. That was the amount; yes, sir.

Mr. BROOKS. That's not as much as the others we've been discussing, but it indicates another system of gradually beating us out of money—trimming and chipping and clipping.

What would you estimate the total windfall profit to be over the last few years, as a result of reductions in subcontractors' prices that were negotiated after the prime contracts had been agreed to?

Mr. CONAHAN. As I said at the outset of our statement, Mr. Chairman, we did not make a review that would permit us to make the kind of scientific projection that you are asking at this point.

It clearly would be significant, but I really think, on the basis of our review, we should not attempt to really put a number on it or to quantify it.

Mr. BROOKS. But on the facts that we received from you, about 50 percent of the $82 billion in noncompetitive contracts was subcontracted. Since 3.2 percent was the average windfall profit on the contracts you reviewed, the potential windfall profit for all subcontracts in 1984 could have been in excess of $1.3 billion.

Do you follow those numbers?

Mr. CONAHAN. Yes, sir, I follow those numbers. And if that percentage was obtained across all of those contracts, that is the number that would result.

And let me add, Mr. Chairman, that is on the basis of the deficiencies in the contract cost estimating systems. There are any number of other problems that exist out there that would begin to increase that number. So we're just dealing with this one part of it.

Mr. BROOKS. I understand. That's bad enough, but there are others.

Well, I have a half dozen or so questions for the record, and I would submit those questions at this point.

[Mr. Conahan's submissions to additional questions of Mr. Brooks follow:]

ADDITIONAL QUESTIONS OF MR. BROOKS
FOR MR. CONAHAN

1. PLEASE PROVIDE INFORMATION ON THE EXTENT TO WHICH GAO HAS DONE DEFECTIVE AND OVERPRICING WORK IN THE LAST FIVE FISCAL YEARS. PROVIDE RESULTING REPORT TITLE AND DATE.

Over the last five years GAO has conducted a number of reviews aimed at assessing how well the Department of Defense procurement process works. Listed below are a number of reports where GAO's work identified defective and/or overpricing situations. In addition to the reports listed below GAO has issued a number of other reports to local contract administration and contract audit offices pointing out areas where procurement functions could be improved.

TITLE	REPORT NO.	DATE
Expediting Fiscal Year-End Awards Results in Shortcutting Department of Defense Acquisition Regulations	Report to Commanding General, U.S. Army Research and Development Command Ft. Monmouth, N.J.	10/7/80
Review of Selected Negotiated Contracts Under the F-16 Multinational Program	PSAD-81-3 B-200193	10/17/80
Contract Overpriced and Established Pricing Regulations and Procedures Not Followed	MASAD-81-16 B-202293	3/15/81

TITLE	REPORT NO.	DATE
Expedited Yearend Contract Award Resulted in Short-cutting Established Regulations and Procedures and Overpricing	MASAD-81-14 B-202277	3/9/81
AWACS Contract Price Overstated Because of Noncurrent, Inaccurate, and Incomplete Cost or Pricing Data	PLRD-81-29 B-168450	5/26/81
Poor Procurement Practices Resulted in Unnecessary Costs in Procuring M-1 Tank Spares	GAO/PLRD-83-21	1/18/83
Contract Overpriced Because of Duplicate Labor Hours and Excessive Material Pricing Rates	GAO/PLRD-83-93	7/7/83
Contract Pricing in the Meals - Ready-To-Eat Program	GAO/NSIAD-83-29	8/8/83
More Effective Use of Audit Reports Needed To Reduce Contract Costs	GAO/NSIAD-83-54	10/11/83

TITLE	REPORT NO.	DATE
Need For DCAA to Improve Both the Reporting of Audit Results and the Management of the Defective Pricing Program	GAO/NSIAD-84-131	7/9/84
Army Contracts Overpriced Due To Misapplication of Spares Formula Pricing Factor	GAO/NSIAD-85-27	3/22/85
Overpricing on Naval Nuclear Contract	GAO/NSIAD-85-92	9/30/85

2. WHEN WAS THE LAST TIME (BEFORE THE CURRENT REQUEST WORK) THAT GAO EVALUATED SUBCONTRACT COSTS IN PRIME CONTRACTS? PROVIDE A LISTING OF CONTRACTOR LOCATIONS VISITED AND IDENTIFY ANY FINDINGS THAT ARE THE SAME AS THOSE IN THE CURRENT REVIEWS. CITE ANY ENSUING REPORTS.

GAO has performed several reviews where subcontract costs may have been examined. However, the last time a specific review was made of subcontract costs was in 1981. GAO initiated a survey in February 1981 to examine the effectiveness of subcontract price proposal evaluations in the pricing of noncompetitive DOD prime contracts. Work was performed at

--Hughes Aircraft Co.; Fullerton, CA.

--General Dynamics Pomona Division; Pomona, CA.

--Pratt & Whitney Aircraft Group; East Hartford, Conn.

--Vought Corp.; Dallas, TX

Two products were issued. A letter report was issued to the Commander, U.S. Air Force Electronics Systems Division which pointed out (1) the contracting officer did not obtain prospective subcontractor cost or pricing data from Hughes nor cost analysis as provided in Defense Acquisition Regulations for major subcontract effort. GAO showed that Hughes obtained a price proposal from the subcontractor after the prime contract was awarded and negotiated a price reduction of $3.9 million or 35 percent below the subcontract estimate in the prime contract proposal. The report pointed out that the subcontract should have been set aside for future pricing when firm evaluations and other data was available. The report also identified another major subcontract where a government cost analysis was not completed in sufficient time for use in prime contract negotiations.

A second letter was issued to the DCAA Boston Regional Director and identified 15 subcontracts priced $955,000 less than amounts disclosed to the Air Force contracting officer. DCAA had scheduled a defective pricing review of the prime contract and GAO requested the agency to specifically consider this information in its review.

3. PROVIDE THE SAME INFORMATION AS REQUESTED IN QUESTION 2 ABOVE WITH RESPECT TO COST ESTIMATING SYSTEMS REVIEWS.

The most recent review of cost estimating systems was in February 1980. We examined DOD surveillance of contractors' cost estimating systems for pricing noncompetitive contracts. The work was performed at:

--Northrop Corp., Aircraft Group
Hawthorne, CA.

--Ford Aerospace and Communication Corp.,
Newport Beach, CA.

--General Dynamics Corp.
Pomona, CA.

--Hughes Aircraft Co.,
El Segundo, CA.

A letter report was issued to the Defense Contract Audit Agency, Los Angeles Regional Director on November 3, 1980. We found that (1) planned surveys and follow-up reviews were significantly delayed or postponed at all four locations and, (2) at some locations, the surveys were marginal in the planning, execution, and coordination phases. All reports could have been written in a more convincing fashions.

4. REGARDING THE $42 MILLION IN WINDFALL PROFITS ACHIEVED BY PRIME CONTRACTORS, PROVIDE A SCHEDULE SHOWING AMOUNTS ACHIEVED BY EACH CONTRACTOR.

SUMMARY OF FAVORABLE FINANCIAL RESULTS IN SUBCONTRACT PRICE NEGOTIATIONS FOR PROSPECTIVELY PRICED SUBCONTRACT COST ESTIMATES OVER $1 MILLION (COMPETITIVE AND NONCOMPETITIVE

Prime contractor	Subcontract cost estimates			Results favorable to prime contractor	
	Number	Negotiated in prime contract (000)	Negotiated subcontracts (000)	Gross (000)	Net[a] (000)
General Electric	17	$108,361	$ 95,942	$12,419	$12,419
Martin Marietta	2	2,696	2,549	147	37
McDonnell Douglas	1	5,491	5,949	(458)	(458)
Raytheon	5	116,624	115,936	688	172
RCA	1	5,106	4,512	594	594
Boeing	6	22,635	22,143	492	492
FMC	28	403,466	389,718	13,748	7,190
General Dynamics	8	41,010	39,434	1,576	1,186
Hercules	13	68,596	57,057	11,539	2,431
Texas Instruments	6	11,092	9,824	1,268	1,268
Total	87	$785,077	$743,064	$42,013	$25,331

[a]After reduction of the government share ratio for FPI contracts.

5. WHAT WERE THE EXPLANATIONS PROVIDED FOR MISCLASSIFYING NONCOMPETITIVE CONTRACTS AS COMPETITIVE? DOES THE GOVERNMENT HAVE ACCESS TO THE ACTUAL COST RECORDS PERTAINING TO THESE MISCLASSIFIED CONTRACTS? IS THERE ANY INDICATION OF FRAUD IN THESE CASES?

In the case of FMC, the company intended to award the subcontracts competitively. And, in fact, FMC did ultimately award the subcontracts competitively. However, FMC had only one quote prior to prime contract negotiations and that one quote was the basis for the subcontract estimate included in the prime contract price. And, more important, no cost or pricing data was obtained or evaluated to determine the reasonableness of the single subcontract quotes. As pointed out in our testimony FMC was able to negotiate about $3.7 million in price reductions with its six subcontractors below the amounts included in prime contract prices.

The government has access to the actual cost records pertaining to these subcontracts and GAO used some of the data to identify the price reductions that occurred after prime contract negotiations. GAO did not find any indication of fraud in these cases.

6. WITH RESPECT TO THE POSSIBLE DEFECTIVE PRICING FINDINGS OF GAO, IT IS THE COMMITTEE'S UNDERSTANDING THAT GAO'S WORK WAS DIRECTED AT IDENTIFYING SYSTEMIC DEFICIENCIES AND WAS NOT SPECIFICALLY DIRECTED AT IDENTIFYING DEFECTIVE PRICING PER SE. CAN IT BE SAID THEREFORE, THAT THE DEFECTIVE PRICING FINDINGS IDENTIFIED ARE A BY-PRODUCT OF GAO'S REVIEW AND THAT OTHER DEFECTIVE PRICING RELATED TO SUBCONTRACT COSTS COULD STILL EXIST? EXPLAIN.

GAO's review of subcontract prices was focused on determining whether the prime contractor and DOD contracting officers were complying with the safeguards contained in procurement regulations for ensuring that the subcontract costs included in prime contract prices were

fair and reasonable. GAO examined records at prime contractor locations; GAO did not perform work at subcontractor locations. GAO's work also focused on the high dollar value subcontracts. In view of the above, it can be said that GAO's review was not specifically directed at identifying defective pricing. GAO did, however, perform limited tests to identify defective pricing on the high dollar subcontract estimates contained in prime contract prices. As a result, defective pricing related to subcontract costs could still exist.

7. WHAT HAS BEEN DOD'S POSITION ON GAO'S CONCLUSIONS AND RECOMMENDATIONS RELATING TO CONTRACTORS' COST ESIMATING SYSTEMS?

GAO has held informal discussions with DOD and DCAA officials regarding our estimating systems work. The officials generally agreed with the results of our work and shared our view that improvements are needed in DOD's surveillance program.

GAO has not formally made conclusions and recommendations to DOD regarding the surveillance of contractors' cost estimating systems. A report containing the results of GAO's work at all 10 contractor locations is scheduled to be issued to the Secretary of Defense by December 31, 1985. The report will contain conclusions and recommendations for strengthening DOD's surveillance of contractors' estimating systems.

8. THE EXAMPLE OF COSTS FOR DESIGN CHANGES AT MARTIN MARIETTA SUGGESTS GROSS OVERPRICING. WHAT ARE THE CONTRACTING OFFICER'S POSITIONS WITH REGARD TO OBTAINING A RECOVERY FROM THE CONTRACTORS?

The example of costs for design changes is a good illustration of what happens when there is not common agreement among the contractor, DOD contracting officer,

and DCAA auditor on what are acceptable estimating practices. The situation is analogous with overhead settlements which have been a focus of attention over the last couple of years.

The contractor proposed what it believed to be reasonable costs for design chances. DCAA believes Martin Marietta's practice of proposing such costs is an estimating deficiency because the contractor's proposed costs are based on estimates rather than costs shown in the accounting records. Because the deficiency has not been resolved, contracting officers are forced to deal with the issue on a proposal-by-proposal basis. GAO found that the contracting officers were allowing most of the company's proposed costs. GAO believes the issue should be dealt with as an estimating system problem. If the costs are not reasonable, the costs should be eliminated from proposals and therefore not be subject to the negotiation process. There is no effort underway by the government to obtain these funds.

9. IS THERE ANY WAY TO OBTAIN A BALL PARK FIGURE (OR PERHAPS A RANGE) OF THE EXTENT TO WHICH CONTRACT PRICES ARE INCREASED AS A RESULT OF COST ESTIMATING SYSTEM DEFICIENCIES?

GAO can not estimate the extent to which contract prices are increased because of cost estimating system deficiencies. However, DCAA continues to question a significant amount of costs proposed by contractors. In fiscal year 1984, for example, DCAA questioned about $25 billion. GAO believes a good portion of those questioned costs is caused by estimating deficiences.

10. WHEN DID THE DEFENSE COUNCIL ON INTEGRITY AND MANAGEMENT IMPROVEMENT DIRECT THE ESTABLISHMENT OF A TASK FORCE TO REVIEW PROCUREMENT REGULATIONS COVERING OVERHEAD COSTS? ARE THERE ANY INDICATIONS OF THE FINDINGS OR ACTIONS OF THIS TASK FORCE?

The council established a task force on June 5, 1985 to review the procurement regulations governing overhead. The task force is scheduled to meet in November 1985 to review each overhead cost principle.

Mr. BROOKS. I recognize Mr. Saxton.

Mr. SAXTON. Mr. Conahan, you indicate that the way this process works, prime contractors have the primary responsibility for negotiating with subcontractors and supposedly providing the Government information as to evaluation of those subcontract prices. Why isn't this providing the safeguards necessary to prevent overspending by DOD?

Mr. CONAHAN. Well, I think one of the primary reasons is that the DCAA has not made reviews of the cost estimating systems of the contractors. I believe that we found, in the 10 contractors, that in many cases no one had knowledge at all of when the last time DCAA had made complete reviews of the cost estimating systems. Where we found that reviews had been made by DCAA—there was one made in 1980, and the others were made back in the 1960's or possibly early 1970's—so I think that the key here is to get DCAA to discharge its responsibilities for periodically reviewing these systems.

Mr. SAXTON. DCAA currently does have the responsibility to do that; is that correct?

Mr. CONAHAN. Yes, sir.

Mr. SAXTON. Why is it that it doesn't get done, in your opinion?

Mr. CONAHAN. I think that DCAA feels that it gets a greater payback from doing real time reviews. It is called upon by the contracting officers to review price proposals. It sees a payback from that kind of work. It does incur cost reviews, and it sees a payback from that kind of work.

It's kind of difficult, really, to quantify the savings that would occur as a result of improvements in cost estimating systems. But those savings are real, and I think that they are both short term and long term, and I think that we need to see some shift of DCAA's resources into doing those kinds of reviews.

Mr. SAXTON. When you say, "a shift in their resources," are you speaking of the timeliness of how the process works?

I gathered from your statement that there are times when evaluations are provided subsequent to the actual negotiations; is that correct?

Mr. CONAHAN. They are, but they are on an individual contract or subcontract basis. I'm talking about taking a look at the overall system employed by the contractors for estimating their costs.

It's somewhat analogous to the overhead question that we're talking about. You know, if we can get costs out of there before they go into negotiations, we're going to be better off. That's the reason that under the overhead cost situation, we want the regulations to be unambiguous, so that these costs are determined to be unallowable. Once they're determined to be unallowable under Cost Accounting Standard 405, "Accounting for Unallowable Costs," they are set aside, and they are not again permitted to be entered into negotiations.

Now if we could get cost estimating systems out there which would ensure that up-to-date quotes and subcontractor proposals are indeed being brought to the table, rather than outdated information and that sort of thing, we are going to exclude costs, up front, that otherwise get entered into negotiation.

So I think that we need to achieve that sort of a situation, and you've got to work on the systems to get there.

Mr. SAXTON. Do you believe that DCAA should be more directly involved in the negotiation of subcontracts or the evaluation of those negotiations or the evaluation of the pricing?

Mr. CONAHAN. I think that insofar as the evaluation of the procurement action is concerned, that would be a responsibility of the Department of Defense inspector general and ourselves, rather than DCAA.

I see DCAA as actually performing the audit of the contractor proposals and the contractor-incurred costs and contractor systems, such as the cost estimating system. But insofar as DCAA then coming in after and actually making an evaluation of that procurement transaction, it is somewhat part of that procurement transaction, and I think that that evaluation should be left to someone else, the IG or ourselves.

Mr. SAXTON. Thank you.

Mr. BROOKS. Mr. DioGuardi, the only accountant we have on the committee.

Mr. DIOGUARDI. Certified public accountant.

I've got a couple of broad questions. One, why do we still have so many contracts on a noncompetitive basis in Government?

Now this may be a very broad macroquestion, but I'm led to believe that there's a tremendous imbalance as to what is competitively bid and what is noncompetitively bid. And in view of the problems that we have in estimating costs and taking things out of the marketplace, why don't we have more and more contracts on a competitive basis?

Mr. CONAHAN. I guess I'm going to defer to our witnesses from the Department of Defense later this morning on that.

I think that we would agree that there are reasons for noncompetitive contracts, and I think that we've attempted over the years to decrease the level of those sorts of contracts and to increase competitive contracts.

We have not, ourselves, in any systematic way looked at that, so therefore I'm not really able to give you a good answer. I really am not.

Mr. DIOGUARDI. OK. But I think it's in the Government's interest to see that that percentage is dramatically increased, and we'll just have to see how it's going to be done.

Who has the responsibility for promulgating cost accounting standards or other standards for determining what the overhead is of the contractors?

Mr. CONAHAN. If we are talking in terms of the cost accounting standards which were promulgated from 1970 to 1980, as you know, the Cost Accounting Standards Board was terminated in 1980.

Mr. DIOGUARDI. That was going to be my next question, as to whether or not——

Mr. CONAHAN. And we feel that there needs to be some reinstitution of an organization that can continue to promulgate accounting standards and to make adjustments to those that are now in existence, to the extent that they need to be modified.

The Department of Defense, of course, does have the authority to promulgate accounting standards for defense contractors. But we

believe that cost accounting standards should be Governmentwide and not applicable just to a single agency.

So we have been suggesting over the past several years a reconstitution, if you will, of some organization that can promulgate standards Governmentwide.

Mr. DIOGUARDI. So that right now there does not exist an independent board or agency, apart from the Department of Defense, in promulgating these standards?

Mr. CONAHAN. That's correct, sir.

Mr. DIOGUARDI. I think that's something we have to revisit because of the lack of scientific application in this area.

Why should any competitive contract or noncompetitive contract go ahead until the prices from the subcontractors have at least been properly compiled, let alone verified? Why is it that we have situations, as we've seen in your testimony, major situations where we're allowing the contracting officer to go ahead and bind the Government before we really see the subcontracting prices and commitments?

Mr. CONAHAN. I think that the contracting officers feel a pressure to move forward with the procurement. The system in the Department of Defense is one that moves everyone toward the fielding of these major weapons systems, and all support mechanisms seem to buy into that sort of a drive. So that the contracting officer is under a certain pressure to move forward, and in the absence of the safeguards that we were talking about, you have the outcomes here that we've also discussed earlier.

Mr. DIOGUARDI. Well, in the private sector, poor planning is usually the excuse for a rush job. It would seem to me that what may be happening here is that we're not providing enough leadtime and strategic planning on these things, so that pressure is on to get it done right away, to get it out there, and we're not getting the benefits that we can by looking at these costs on time. I'm just drawing from my experience in the private sector.

What about the compensation of these contracting officers? What does the average contracting officer earn?

We're talking now of an employee of the U.S. Government?

Mr. CONAHAN. Yes, sir.

Mr. DIOGUARDI. Not an independent contractor, an employee of the Government.

Mr. CONAHAN. An employee of the Government.

Mr. DIOGUARDI. What is the average scale of compensation for a contracting officer?

Mr. CONAHAN. On average, I believe the major weapon system contracting officer would be the GS-13/14 level, which is between $40,000 and $50,000.

Mr. DIOGUARDI. OK. So again, we have, to my mind, a big, weak link in the system. We have people now binding the Government for billions of dollars, and they are earning somewhere between $40,000 and maybe $60,000.

They have major responsibilities and come under a lot of pressures for that amount of pay, it seems to me. I wonder if the public's interests would be better protected if contracting officers received salaries that could climb closer to what their counterparts

in the private sector make. Certainly we could keep the outstanding ones in Government service longer. That's question No. 1.

Question No. 2 is, when these contracting officers fall down, why aren't they fired on the spot?

Mr. CONAHAN. If this were the—I don't want to make light of this, honestly, but, you know, before the House Post Office and Civil Service Committee, you know, I would make the case for increases in Government salary. And I'm not really sure how you go about that.

If you are suggesting that the contractor's contracting officer is much more highly qualified because that individual is getting a higher salary, I quite frankly don't know how to fix that in the scheme of things right here.

Mr. DIOGUARDI. Well, Frank, I think what I'm saying is that we've seen, by past experience, that the turnover in the Government is so great—we educate them, and all of a sudden they get on the other side of the table, because they're being paid not $40,000 or $50,000, but many times $150,000 and $200,000, and we have to then scurry around to find someone to fill that hole.

Now I'm an elected official. I know when I run for office that I'm going to be paid so much. I elect to do that. But it seems to me in Government we ought to be looking to keep the best minds we can, when we're talking about billions of dollars.

And, Mr. Chairman, the weak link in our system, I think, is that we don't have the incentives to attract these people, and we're constantly having hearings, talking about these disasters, because we have around Government people who are overburdened and in many cases probably not earning what they could outside. The incentive is to leave Government to go to the other side of the table, which we've seen, and in some cases, I think, a lot of that is probably very wrong and maybe illegal, too. I don't know.

Mr. BROOKS. Let me say to my distinguished friend, whose observations are very penetrating, that all administrations face this problem.

Civilian salaries are tied to congressional pay and Congress has a built-in reluctance to raise the pay of its own Members.

But that's what the problem is. They can't raise those salaries very much, and you might as well face it. These contracting officers and the people who work in the General Accounting Office who analyze these problems in Government functions, objectively and with courage and with ability and with dedication, are in the same price range more or less.

But they don't work just for money. They work for satisfaction, for contributions to the country. And many of these people work long hours, conscientiously, and without being bribed, and without being influenced.

And they resist a lot of temptation, I suppose, and do a good job for the Government. But you have a steady problem of finding qualified people.

There are some people who work for the Government in contracting, who, as soon as they learn their job, they quit to take a job with the first contractor that offers them work.

This is the way it goes. I think it's a problem that we ought to face, and we ought to encourage the appointed people in the De-

fense Department to do a better job. They get a lot of recommendations that they don't pay any attention to.

And you're right when you say that the whole problem is that contracting officers are not paid commensurate with their responsibilities. They obligate the Government for millions of dollars that we taxpayers must ultimately pay, because if a contracting officer approves a contract, we may not have any recourse to recoup any windfall profit made under that contract.

That is disgraceful. When you have these contracting officers binding the Federal Government for many millions of dollars, that puts the Government in a very vulnerable position.

Mr. DIOGUARDI. That leads to my next question.

What is the role of the GAO or the IG in auditing the evaluation procedures of contracting officers and how they are evaluated for promotion, dismissal?

Is there some kind of qualitative, as well as quantitative, audit when it comes to personnel in positions as sensitive as this?

Mr. CONAHAN. We have, as an organization, done some work taking a look at the appraisal systems of other agencies. I cannot call to mind that we specifically looked at the appraisal of contracting officers. I do not believe that we've done that.

Mr. DIOGUARDI. Well, Mr. Chairman, that could be another weak link, if the GAO—and we will hear from the IG in a minute—doesn't get into the evaluation procedures by the Department of Defense on the performance of these contracting officers. If they don't, in other words, there is no outside agency auditing, from a qualitative point of view, the performance of those officers, looking at the record as to what may have happened.

Mr. BROOKS. You can give that question to the inspector general.

Mr. CONAHAN. And, Mr. DioGuardi, let me say that we do comment on the activity of contracting officers in all of these reviews that we do concerning the procurement of weapons systems over there.

This one today, we're commenting on the role of the contracting officer there and the unallowable costs. We did the same and so on. So that there is a review of their activity, of their performance, in that sense. But insofar as the formal appraisal system goes, I just can't call that one to mind.

Mr. DIOGUARDI. All right. I think overall the GAO does a great job. I just felt that that was a question I should ask, because it seems to me that we've got to look at people as well as dollars when it comes to what's going on in Government.

My final question is, where does the role of the IG fit in alongside the GAO and the DCAA?

In other words, you are now doing an audit of what has happened here on these noncompetitive contracts. Is there a day-to-day role for the IG in this before you get involved?

Mr. CONAHAN. I believe that there is a day-to-day role for the IG, not only before but in consonance with what we're doing. I think that the IG will tell you later that they are also looking into this matter.

We see no duplication there. We see that we complement one another's efforts in what we're doing.

The DOD IG has a role to report jointly to the Secretary of Defense and to the Congress here, and our role is exclusively to the Congress, though we do make recommendations to the agencies for action.

Mr. DIOGUARDI. Thank you for your testimony.

Mr. BROOKS. Thank you. And the Chair recognizes the gentleman from North Carolina, the distinguished defender of the American textile industry, Stephen Neal.

Mr. NEAL. Thank you.

Mr. Chairman, I just noticed that so few of the contracts are competitively bid. Didn't we pass legislation around here last year or the year before, requiring that there be competitive bidding in this area?

I believe you took a leading role in that legislation. What happened there?

Mr. BROOKS. The Defense Department could run a camel through the eye of a needle. They use every possible excuse they can think up to avoid competitive bidding on anything.

Mr. NEAL. We did finally pass that legislation, didn't we?

Mr. Conahan, do you have a comment on that?

Mr. CONAHAN. Yes, sir, that legislation was enacted.

I guess if I could refer to a review that we completed recently for another subcommittee of the House, relating to support equipment being purchased for the F-16 aircraft, for the maintenance of the radar on the F-16 aircraft, in that case the Department of Defense issued an unpriced contract, as a matter of fact, on the grounds that there was an urgency for the tool kit with which to maintain the radar on the F-16 aircraft.

That decision was made in September 1982, and at that time, they, themselves, had determined that they weren't going to do that repair and maintenance until late 1984 or over 2 years later. And as a matter of fact, as of a couple of weeks ago, they still hadn't gotten around to doing any maintenance in-house. It's being done by a contractor.

Now here was a case where they defended the urgency associated with that sort of a transaction. It's unexplainable to me, and you find an awful lot of that over there.

Mr. NEAL. Well, the reason I mentioned the legislation is because it sounds to me like what you're suggesting here would be illegal, would it not? I mean, if we've passed legislation saying that there will be competitive bidding, and there is not, isn't that a violation of the law?

Mr. CONAHAN. Well, I guess, you know, there are very few things quite that simple. And if you take a look at the justification underlying these transactions, it becomes somewhat unclear. When you strip it all away and spend enough time, you can see clear violations of regulation. I'm not sure that there are clear violations of law in any of this, but clear violations of regulations.

Mr. BROOKS. My friend, Mr. Neal.

Mr. NEAL. Yes, sir.

Mr. BROOKS. Maybe we ought to take a look at the exceptions provided in the law. Some exceptions were written in, because there are obvious instances where you might have an emergency. But everything isn't an emergency. Every exception that you ever

grant them, they magnify, multiply, and, I think, distort, but yet they claim it's a matter of judgment. You have trouble proving that it is not an emergency. You know, at the time they say it's just vital and critical, but as in the instance that Frank Conahan points out, they weren't planning to do the work for 2 years. But they say it's an emergency in 1982, even though they weren't planning to do it until 1984. They haven't done it yet.

So maybe we ought to work on those exceptions and make them more specific.

Mr. NEAL. You're suggesting maybe a change in the law, then?

Mr. BROOKS. Yes. We might change that a little. They'll just squirm a little more. They probably will not change very much, because they're resourceful.

Mr. NEAL. I don't know. I've come to think that we do need some incentives for people to do things efficiently in our Government agencies, aside from various laws, but I would think the law would help. I mean, that might provide a little carrot and a stick, if we could base some promotions on how efficiently people do things, as well as considering other factors, but also say, "We've got a law here, and you won't comply with the law," that there ought to be some little disciplinary action there, too.

Mr. BROOKS. If they fired any contracting officer who wasted over a million dollars in Government money, it would help.

Mr. NEAL. You think that would be the cutoff point.

Mr. BROOKS. Let that be the cutoff. If you're wasting a million dollars of Government money, you are going to lose your job.

Mr. NEAL. Maybe slap their wrists at that point, and if it's $10 billion, then what? A demotion one rank?

Mr. BROOKS. If someone figures out a way to steal $10 billion from the Government at one time, which they might do in one of these big, new systems, he'll become chairman of the board of the company he helped.

Mr. NEAL. All right.

Mr. BROOKS. Mr. Rowland, the gentleman from Connecticut.

Mr. ROWLAND. Thank you, Mr. Chairman. Who said we can't have any fun on this committee?

Let me follow up on the competitive bidding discussions that we are having.

In the testimony, we've seen that approximately half of DOD's contracts were done without competitive bidding. And we are discussing now about instances where competitive bidding cannot be used.

In the reviews that you did—and I know that those were more limited in scope—would you say that there were opportunities to have two or more companies competing on some of those contracts?

Mr. CONAHAN. We did not explicitly look into that matter. What you have here is a relationship that builds up. When you have follow-on contracts, it probably makes sense to continue—or it could very well make sense to continue with the same contractor without competitive bidding. And there are other reasons for competitive bidding.

But all in all, I think, without having before us the analysis to support an answer to your questions in the specificity that I would

like to do it, there are certainly opportunities to increase competition.

Mr. ROWLAND. Are you saying that continuing relationships are more important or as important as saving money?

Mr. CONAHAN. No, sir. I'm saying that it exists.

Mr. ROWLAND. And would you say—and I don't want to put you on the spot—that that may be the indication in many situations, where that continuing relationship seems to be, for lack of a better word, easier than the possibility of reaching out and doing competitive bidding?

Mr. CONAHAN. No, sir, because it's just one thing that sits there. You do see a fair amount of competition with the Government. So it's kind of all over the lot.

Mr. ROWLAND. Let me ask another question. You found a large number of evaluations being prepared by prime contractors, but not prepared in time to be used in negotiations with the Government.

Is the principal problem, in your opinion, with these evaluations, their lack of timeliness?

Mr. CONAHAN. I think that that is a problem in terms of getting adequate evaluations before the prime contract is negotiated with the Government.

What is interesting in many of these cases, there always seems to be time for the prime to do adequate analysis after the prime contract has been negotiated.

Mr. ROWLAND. Well, why aren't they prepared in time, the subs?

Mr. CONAHAN. Well, there is an incentive, if the subcontract has not been negotiated at about the time that we're getting ready to negotiate a prime, there is some incentive for these evaluations not to take place until after the prime has been negotiated.

Mr. ROWLAND. Do you believe that the contractors are purposely delaying preparing these evaluations?

Mr. CONAHAN. We can't establish purpose or intent here, but let me say that the incentive is clearly there for them to do so.

Mr. ROWLAND. You indicate that over half of the subcontracts included in your review were negotiated prior to the conclusion of the prime contract with the Government, as you said.

Did your review indicate any economic advantage to the Government from either subcontracting before the award or subcontracting after the award?

Mr. CONAHAN. I think the key here is good proposals on the part of the subcontractor and good evaluations by either the prime contractor or the Government. If those conditions exist, I think that the Government is in pretty good shape, whenever it occurs and particularly afterward.

In fact, we saw instances where, as I mentioned a moment ago, the prime contractor was pushing pretty hard on the subcontractor, even before the prime contract was awarded. So I'.n not really sure that I see that difference that you're looking for there.

Mr. ROWLAND. In your opinion, can we get to a posture of more competitive bidding or a situation where we can avoid the windfalls? And let me follow it up with another question: Is the only way we can get back the windfalls by lawsuit? Is there any other procedure that you know of? So it's a two-point question.

Mr. CONAHAN. Well, to the extent that the contractor has withheld current and complete information from the Government at the time of negotiation, there is an administrative procedure in place which can result in the recoupment of those funds.

Mr. ROWLAND. You've got to prove that, however, right?

Mr. CONAHAN. Well, what happens is, the administrative contracting officer makes a determination, and if the contractor does not agree with that determination, the contractor has got recourse to the Armed Services Board of Contract Appeals.

Mr. ROWLAND. Did you want to follow up on the other? Can you think of a better way we can avoid the windfall situation?

Mr. CONAHAN. Well, I think in the particular case at hand today, by getting the Defense Contract Audit Agency to increase its reviews of the contractors' cost estimating systems and to put in place a mechanism to assure that the deficiencies that are uncovered as a result of those reviews are corrected, so that the proposal data being presented in the first instance is as current and complete as it can be at that time.

Mr. ROWLAND. OK. Thank you very much.

Mr. BROOKS. Thank you very much, gentlemen. We appreciate your being down here, Mr. Bononi and Mr. Cooper. Thank you, Mr. Conahan.

Mr. CONAHAN. Thank you, sir.

[Mr. Conahan's submissions to questions of Mr. Horton follow:]

QUESTIONS OF MR. HORTON
FOR MR. CONAHAN

1. You indicate three general situations that cause evaluations of subcontract pricing proposals not to be provided as required by prime contractors in their negotiations with the government:

-misclassification of the subcontract as competitive and, therefore, as not requiring supporting price data or an evaluation;

-performance of the evaluation too late to be useful in negotiations with the government;

-failure to perform any evaluation at all.

Q: Would a review of a contractor's estimating system show deficiencies in these areas?

Yes, and at some of the contractor locations GAO visited DCAA had identified these problems as estimating system deficiencies. Contractor Purchasing System Reviews which are performed by DOD contract administration offices also are intended to identify these problems.

Q: What corrective measures would address these deficiencies?

Compliance with existing regulations would correct the deficiencies. Also, not negotiating the prime contract until acceptable cost or pricing data and subcontract cost evaluations are provided would correct the problems.

Q: Would agreement on certain standards for estimating systems help overcome these deficiencies?

Yes, differing interpretations by contractors, contracting officers, and contract auditors have resulted in estimating system deficiencies not being resolved. As stated above, DCAA has identified problems regarding subcontract evaluations as estimating system deficiencies. However, there was no agreement among the contractor, contracting officer, and DCAA regarding the deficiencies because of differing opinions about what procurement regulations required on subcontract evaluations. Further, we believe the cost estimating surveillance program suffers from a lack of (1) clear direction for resolving deficiencies and (2) top management emphasis at all levels, including DCAA.

Q: Given that regulations already require preparation of subcontract cost evaluations, what corrective measures could help overcome problems related to lack of timeliness?

GAO believes that prime contract negotiations should not be conducted until adequate subcontract evaluations are performed and government contracting officers have adequate information regarding the reasonableness of the subcontract estimates included in the prime contractor's proposal. If prime contract negotiations can not be delayed, the procurement regulations provide that the contracting officer can set aside major subcontract costs for future pricing.

2. You found a large number of evaluations being prepared by prime contractors, but not prepared in time to be used in negotiations with the government.

Q: Is the principal problem with these evaluations, as you found it, their lack of timeliness?

Timeliness was not the only problem GAO found [illegible] subcontract evaluations. As we point out on page 9 of our testimony, for example, the evaluations performed by Hercules were essentially desk reviews of the subcontract estimates and did not involve visits to the subcontractors' plants to validate the cost or pricing data submissions. Thus, the problems GAO found with subcontract evaluations involved quality of the evaluations as well as their timeliness.

Q: Why aren't they prepared in time?

GAO found that most contractors were conducting two sets of evaluations--one before prime contract negotiations and another, more thorough, evaluation after prime contract award. GAO believes time should be allowed to get adequate subcontract evaluations.

Q: In the case of the Hercules subcontracts you cite as examples, what kept the evaluations from being provided in time to the contracting officer?

Hercules officials advised us that insufficient time prevented them from conducting more thorough evaluations of subcontract estimates. Our analysis, however, showed that time was available to complete a full analysis of the subcontract estimates before prime contract negotiations. For the two Hercules prime contracts included in our review, the average number of days between the receipt of the subcontract proposal and date of prime negotiations was 152 and 132 days,

respectively. The average number of days between the request for a full analysis and date of the analysis report was 116 and 43 days, respectively.

Q: Do you believe contractors purposefully delay in preparing these evaluations?

GAO found no evidence that contractors purposefully delayed preparing evaluations. On the other hand, the results of GAO work at the 10 locations show that contractors have a strong financial incentive to perform more thorough subcontract evaluations after prime contract award.

3. You note an example in which a prime contractor had completed an evaluation of a subcontract pricing proposal, but had not "formalized" it.

Q: Does this distinction signify that the contractor had information available to him which was unavailable to DOD during negotiations?

The contractor in this case issued an evaluation report one day after prime contract negotiations were completed. The evaluation report questioned a significant amount of costs proposed by the subcontractor. It is, therefore, likely the contractor had information that was not made available to the government.

Q: If so, have you raised this situation as a possible instance of defective pricing?

Yes, GAO staff have discussed the situation with the responsible Army contracting officer and GAO will issue a report to the contracting officer which addresses this issue.

4. Your analysis shows that, depending on how you treat incentive contracts, either about five percent or three percent of prospective pricing included in your review proved to be unjustified by the final outcome of subcontract negotiations.

   Q: Does application of a gross discount factor (a "decrement") demonstrably result in a margin of difference worse than three percent?

   GAO's review showed that contracting officers were using alternative pricing techniques (such as decrement factors) when subcontract evaluations were not adequate. However, the final outcome of subcontract negotiations clearly demonstrates that such alternative pricing methods are not adequate substitutes for good subcontract evaluations.

5. Over half of the subcontracts included in your review were negotiated prior to the conclusion of a prime contract with the government. A significant portion, however, were agreed to after the prime contract had been signed.

   Q: Did your review indicate any economic advantage to the government from either subcontracting sequence?

GAO's review did not specifically analyze the economic advantage from either subcontracting sequence. GAO believes, however, that if a good subcontract evaluation is performed and made available to the contracting officer, the government's interest should be protected.

Q: In the case of prime contracts awarded after subcontracts have already been negotiated, isn't there a potential that economies may be lost because of the lower incentives for primes to press their subcontractors on terms?

Theoretically, yes, because contractor profits are based to some extent on the amount of costs they incur. But, we have not uncovered evidence that this is happening. In fact, we saw some cases where prime contractors negotiated substantial reductions with their subcontractors before award of the prime contract.

Q: Based on the $785 million in subcontracts included in your review which were negotiated after the conclusion of prime contracts, what amount would likely correspond to economies lost under those circumstances?

For 87 of the 100 prospectively priced subcontract cost estimates included in our review, prime contractors were able to achieve subcontract price reductions of $42 million below the amounts negotiated in prime contract prices. The other 13 subcontract estimates had not been priced at the time of our review.

Q: What percentage is that?

Prime contractors reduced subcontract prices by about 5.3 percent below the estimates in the prime contracts for the 87 prospectively priced subcontracts. The 5.3 percent amount takes into consideration the extent to which the subcontract estimates included in prime contract prices had been "decremented".

6. You have expressed concern that unsubstantiated contractor costs which auditors may identify in pre-award surveys are often accepted anyway in negotiations by the contracting officer. Consequently, your recommendations for preventing inflated cost estimates gives first priority to improving estimating systems.

Q: As an audit agency, what prospect does GAO see of having DCAA shift its resources to support that priority, when no dollar payback can be demonstrated from reviews of estimating systems?

Reviews of estimating systems with the view of correcting deficiencies will result in both short-term and long-term improvements and dollar savings. The savings are difficult to quantify but they are nonetheless there. DCAA's 1982 guidance to its field managers makes this same point. The guidance adds that good estimating systems will also reduce audit effort. GAO believes that there is more benefit to getting estimating deficiencies corrected at the system level rather than trying to deal with the deficiencies on a proposal-by-proposal basis. GAO believes also there is a need to shift some DCAA resources to the cost estimating area.

Q: If DCAA is not given sufficient resources to perform this function, could surveillance of this area be accomplished otherwise?

GAO believes, and DCAA agrees, that estimating systems surveillance is an important audit function. GAO further believes the responsibility for estimating system surveillance is properly placed with DCAA. Recent discussions with DCAA officials indicate a desire on their part to improve DCAA performance in this area and to strengthen DOD's surveillance activities.

7. Last year our Subcommittee criticized ambiguity in the areas of advertising and other questionable costs that were being claimed for reimbursement as legitimate public relations costs instead. DOD last week took final steps to change the cost principles covering that area in order to eliminate that ambiguity. The change also incorporates subsequent recommendations GAO made for closing loopholes offered by other, related cost principles.

Q: Do the revised cost principles responsed to the need you have expressed for eliminating abuse in this area?

In February 1985 a proposed change to FAR on public relations and advertising was circulated for comment. This change is a positive step and should eliminate much of confusion concerning these costs. This revision has not yet become effective but, according to DOD officials, it should be promulgated in the FAR shortly. In September 1985 DOD responded to our subsequent recommendations and concurred with most of them. However, DOD has not yet taken action to revise the FAR accordingly.

DOD has also established a task force to review the procurement regulations covering overhead costs to identify ambiguities and loopholes in the FAR. This task force is expected to complete its work in December 1985 and, based on this effort, FAR changes may be made.

Q: In your review of incurred cost audits related to allowability of costs, what years were the claims under review submitted for?

Our review examined the most recent final overhead settlements at seven contractor locations. These settlements were for calendar years 1979 to 1981 and negotiations were concluded as late as March 1985.

Q: In the intervening years, have clarifying changes been made to cost principles that cover some of the items there were questioned in the audits you reviewed?

In addition to the proposed FAR changes on public relations and advertising costs, DOD has clarified the cost principles governing goodwill, self-insurance, lobbying, and travel costs. In addition, the DAR council is preparing revisions to the cost principles which cover compensation, "banked" vacations, and employee discounts.

Q: Will you be monitoring DCAA's experience in those areas with changes to evaluate the effectiveness of the revised regulations?

Pursuant to a request from the Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, GAO has begun a review of DCAA's effectiveness in identifying unallowable overhead costs. GAO will, after sufficient time has elapsed, monitor DCAA's review efforts to determine the effectiveness of the revised cost principles.

Mr. BROOKS. Our next witness is Derek J. Vander Schaaf, deputy inspector general of the Department of Defense. We are delighted to have you here again, and we look forward to your testimony. We accept your statement for the record, and you can speak from that.

And I've got one question on that. On page 8, you say that the Truth in Negotiations Act requires that any prime contract meeting the criteria for certification must contain a price reduction clause.

Do they always put that in?

STATEMENT OF DEREK J. VANDER SCHAAF, DEPUTY INSPECTOR GENERAL, U.S. DEPARTMENT OF DEFENSE

Mr. VANDER SCHAAF. Yes, they put that in.

However, as I get into my statement, you will find that we are not always in a position to make use of that clause, due to weaknesses in the law that I will discuss.

Mr. Chairman, it's a pleasure to be here. That's probably not the right word. It's a challenge to be here again. I look forward to this challenge.

I have a rather long statement this morning. Most members may not have had an opportunity to read it. I would like to take a few more minutes than I normally take and explain the statement. I don't intend to read it. Rather I will highlight the important points. I hope to impress upon you and the public the need for two additional pieces of legislation that we believe would greatly help people in our business and help to recover some of these funds that you have already talked about this morning.

One of these is an amendment to the Truth in Negotiations Act, Public Law 87-653. This law has been in effect since the 1950's.

Mr. BROOKS. Maybe it needs to be tightened up.

Mr. VANDER SCHAAF. That's right. It needs some tightening up.

The other legislation is some program fraud civil penalties legislation. Now I don't intend to spend a lot of time on that proposal this morning, because the Attorney General, Mr. Meese, has proposed an eight-point legislative package dealing with white collar crime. One part of that package is a program fraud civil penalties bill. We can get into that a little later.

In recent years, the interest in this legislation has centered in the Senate Governmental Affairs Committee primarily. There hasn't been much interest shown in this legislation by the House. I would like to generate some interest in that legislation in the House, if I could.

As you know, DOD has 13 internal audit organizations. Of those 13 audit organizations, 12 are located outside of the Office of the Inspector General. The largest of those audit organizations is the Defense Contract Audit Agency. It provides audit services to all defense procurement and contract administration organizations. That organization is under the direct control of the Comptroller.

When creating the IG in 1982, Congress decided that we should have a capability to review the work of DCAA, and it provided us with the contract audit capability to carry out that responsibility. We are using our contract auditors for that purpose. These con-

tract auditors do not advise contracting officers with respect to financial services and matters involving the negotiation of contracts.

The policies and procedures for the Defense Contract Auditing Agency are set out in various departmental directives and memorandums, the DCAA audit manual, certified public accounting directives, and the like. Therefore we have not had reason to write a great deal of new policy with respect to what DCAA does. Rather we have put most of our attention on oversight reviews of DCAA. We have issued policy guidance when we believed it was necessary. We have also issued policy guidance which I have referred to in my statement.

Mr. Chairman, some of our oversight reviews have concerned access to contractors' records, reporting of fraud or illegal acts, adequacy of defective pricing audits, coverage of subcontractor pricing proposals, and effectiveness of operations of DCAA in mobile incurred-cost type audits.

I believe your staff has had access to all of these documents.

This morning I want to discuss three areas which we believe require additional audit emphasis. They are defective pricing, contractor estimating systems—in other words, auditing the accounting system, rather than auditing the results of the accounting system—and subcontractor proposals. I believe that greater emphasis in these three areas could bring about significant improvements in acquisition management within the Department of Defense.

The first item is defective pricing. As I said earlier, defective pricing is a condition which results from a violation of Public Law 87-653. The whole reason for that law was to put the Government on an equal position with the contractor during the price negotiations. The objective was to avoid excess pricing by contractors.

This act requires that the contractor submits cost or pricing data to the Government. The contractor must certify that, to the best of his knowledge and belief, the cost and pricing data are accurate, complete, and current at the time it is submitted.

There are a number of exemptions from the requirement to file such a certification or to gathering what we call cost and pricing data. It is two of these exemptions that I want to call to your attention. We have identified some problems in the use of these exemptions.

The first exemption applies when we have competitive bidding. The second exemption is when the contractor claims that there is a catalog or a market price for the item being purchased. In other words, the item is a commercial item, and the price should be set in the marketplace. We don't need the cost and pricing data in these situations.

Regardless of the presence of all of these conditions, the contracting officer has the right to insist on the submission of cost and pricing data, if he feels that it is necessary. Our office has suggested to contracting officers on a number of occasions that, even though these two criteria or exemptions may appear to be available, it might be in their interest to request some cost and pricing data and go through the extra work. This is particularly true when two contractors are offering a different sort of a technical approach to the same request for proposal. Although we may say we have price competition; we may in fact have more technical competition

rather than price competition. We must be careful to get cost and pricing data in these situations.

We've also found examples where one contractor may control a significant portion of another contractor's proposal. In those cases, it is our opinion that the Government should always get cost and pricing data.

Finally, with respect to cataloging or market pricing, we get only a representation from the contractor that the data provided is accurate. We do not get a certification on the accuracy, currency or completeness of sales data when a contractor says that it is providing us a catalog or market-determined price to substantiate his exemption from the Truth in Negotiations Act.

We are in the final phase of an audit covering catalog and market pricing. We are finding that many of the claims for this exemption cannot be substantiated. We have found indications of overpricing as a result of this abuse.

We will be recommending changes in the Federal acquisition regulation to require more audits of such claims for exemption before and after an award. More importantly, we need specific language in our regulations to permit the application of remedies provided for in Public Law 87-653 when the contractor's representation of commerciality is found to be invalid. This must apply even though the contracting officer was or should have been aware that the items being purchased did not qualify for the catalog or market pricing exemption.

My statement contains a long explanation of what cost and pricing data is; what the roles and responsibilities of the contracting officers are; and what the responsibilities of the contractor are to provide the data. I won't cover them here; they are between pages 9 and 18 of my statement.

I want to now turn to the role of the contract auditor in this process. Most reports issued by DCAA involve reviews of contractor pricing proposals prior to the contract award and reviews of costs incurred by contractors and billed to the Government. They spend less time on that. The agency spends only a small portion of its time looking for cases of defective pricing.

During the 6 months ended on March 31, 1985, the DCAA issued 27,021 audit reports. Of the reports issued, 13,411 were issued as a result of reviews of contractor pricing proposals; 11,912 were issued as a result of reviews of incurred costs; and only 537 were issued as a result of defective pricing reviews.

Defective pricing reports accounted for less than 3 percent of DCAA work when we first began reviewing this situation. We believe that this process of looking back over the contractor's original submission of his data is very important to maintaining integrity in the contracting process. It ought to be an important concern to the taxpayer. We believe that Public Law 87-653 is one of the key safeguards in the integrity of this whole process. We are encouraging DCAA to put more of its available resources into defective pricing, and DCAA has responded accordingly, and has made some impressive improvements there in the last 2 years.

DCAA has increased its defective pricing audits from less than 3 percent to some 6 percent of its workload. Through some new hires that the Congress has provided to DCAA, it will be able to move its

defective pricing efforts up to about 7.4 percent of its total audit time.

I would like to discuss the quality of some of DCAA's reports and some of the problems that we have found in the past.

In one of our reviews, we looked at defective pricing audit reports, and we selected a sample of some 216 reports which contained descriptions of defective pricing situations which could possibly be indications of fraud. We were concerned that some of the audit personnel in DCAA had not been properly sensitized to the possibility of fraud in this area; that is, the cost and pricing data was knowingly submitted to the Government and was known to be false by the people who submitted it.

We took a look at those cases and identified 22 of them which we felt ought to have additional screening. DCAA then did this additional screening. Three of those cases were eventually referred back for further investigative work, and I believe, as a result of that, two of them have proceeded to indictment.

The quality of DCAA reviews varies. We found that there was extensive guidance on defective pricing within the Defense Contract Audit Manual and other policy and procedure guidance. However, we found that some audit offices did not maintain a complete inventory of the contracts. We also found that the lead sheets for selecting contracts with the highest probability of containing inaccurate cost or pricing data was not prepared and used, and lower priority audits were completed before defective pricing audits.

With respect to sustention rates on defective pricing reviews, we are concerned that auditors are not being sustained to the extent they should be, particularly in defective pricing cases. Our analyses indicate that only about 38 percent of the recommendations of DCAA were substantiated, rather than the 60-percent sustention rate that they reported. The major reason for the differences in sustention rates was the manner in which DCAA reported cases when the contractor appealed a contracting officer's unilateral decision.

Although the DCAA considered the contracting officer's determination as 100 percent sustained, we think there is no sustention unless there is a contract modification or a payback of moneys to the Government. We have reached an agreement with DCAA that they will caveat the net savings figures reported outside of DCAA and indicate the amount of net savings reported that have been appealed.

The more recent reviews and analyses by our staff continue to show that DOD components and DCAA are reporting vastly different amounts and rates for the sustention of contract audit findings in general. Here, I am not just talking about the defective pricing audits. However, the differences reported in sustention rates for defective pricing audits have been largely eliminated as a result of our longstanding interest in these audits. Nevertheless, we remain concerned over the relatively low sustention rate achieved in defective pricing audits.

During the last semiannual reporting period, which ended in March 1985, the sustention rate for defective pricing audits was 31.4 percent. That is well below the 50.4-percent rate for other types of contract audits. This poor sustention rate for defective

pricing audits was due in large part to the low sustention rate of 12.4 percent reported by the Navy.

In my statement I have an appendix which displays the sustention rates on defective pricing by the various agencies within the Department of Defense. I also included a listing of the contract audit followup reviews that we have made in 1984 and 1985, as well as some of the problems we have found. I will mention the most significant ones at this time. They are on pages 22 through 24 of my statement.

There is a lack of communication and cooperation between many contracting officers and DCAA auditors.

We found instances of inadequate price negotiation memorandums. They lacked the specific comments required by the Federal acquisition regulation on the extent of reliance on the cost and pricing data provided by the contractor. If the contracting officer has not relied upon this data, then we have no defective pricing. It is important that he so state in his price negotiation memorandum.

A third problem we found was competing demands for contracting officers' and auditors' time, primarily assigning a priority position to preaward and forward pricing audits at the expense of defective pricing reviews.

Finally, we have seen a failure by some DOD managers to reallocate resources to enable timely resolution and disposition of defective pricing audits. For example, we recently found eight defective pricing audit reports which had been sitting in a Navy office of counsel for over 1 year awaiting legal review.

We have made a number of recommendations to correct this situation. Some of those recommendations were mentioned briefly by Mr. Conahan. I won't go into those at this point, but they are on pages 24 through 26 of my statement.

We believe the key to solving these problems is increased interest by senior level management and the expression of that interest to their staffs and especially to industry. Active involvement by management in supporting contracting officers and auditors will demonstrate to industry that DOD takes defective pricing very seriously, and that we expect cooperation from contractors as a condition to doing business with the DOD.

Mr. Chairman, the next part of my statement deals with the program fraud civil penalties legislation. I don't intend to take much time discussing this. As I mentioned earlier, the administration has now come forward with a proposal of its own, and supports this type of legislation.

I do find it rather ironic that the Health and Human Services Department has had this type of legislation available to them for a number of years. They may seek restitution from doctors who mischarge the Federal Government on health care, on Medicare and Medicaid. However, the Department of Defense does not have such authority to pursue contractors who commit frauds against the Department of Defense.

The last subject I want to comment on is the need for more reviews of contractor estimating systems. Mr. Conahan, again, stressed this in his statement, and for that reason some of this may be a bit repetitious.

We feel that quality contractor estimating systems are the essential element in assuring that contract awards are based on current, complete, and accurate information. Therefore, we are currently conducting oversight reviews of contractor estimating practices. Although we are only in the survey phase of our review, we have found instances where auditors have repeatedly reported deficiencies in estimating systems to contracting officers with no action being taken to correct the problem.

We have discussed this with the contracting officers, and they have stated that they do not have the leverage to make the contractor correct the problem. I have a problem with their response. Their leverage is, "Hey, we don't go to contract, if I don't get the cost and pricing data I need to understand what we're doing."

It seems to me, they have plenty of leverage. We have to see it from the contracting officer's standpoint also. He's under pressure from upper management from time to time to get a contract. So he sometimes is willing to overlook some of these discrepancies in the price and cost estimates which are provided.

Estimating systems need to be reviewed as systems, not in pieces or parts of reviews of individual contract proposals. It is only when reviewed in their totality that conclusions can be reached as to their overall correctness. It is only through a systems review that patterns emerge of how contractors treat certain kinds of costs.

For example, when a contractor's estimating system is found to have a pattern of overestimating engineering costs, the defect in the estimating system needs to be corrected. This should be done as part of a review of the estimating system, as opposed to attempting to correct for erroneous estimates when evaluating the individual proposals that the estimating systems produce.

Furthermore, a pattern of overestimation of engineering costs may not be apparent in evaluating individual proposals when a great number of proposed costs are to be reviewed in a short period of time. An audit of the system to ensure that it produces current, complete, and accurate data would be better than just checking the proposed amount. A system audit approach corrects the data before it enters the proposal.

Although we emphasize the importance of estimating systems review to produce current and accurate data, we must also be diligent in testing the data through an aggressive program of defective pricing audits. When these audits demonstrate that the estimating system is producing defective data, aggressive corrective action must be taken. It is not enough just to issue defective pricing reports and ignore the root cause of the defect.

The last subject that I wanted to treat this morning is major subcontractor pricing proposals.

Generally, we have found that the DOD internal audit agencies placed very little emphasis on evaluating subcontractor management areas such as negotiation of contract prices for subcontracts. The DCAA, however, generally provided timely, quality audit assistance to DOD contracting officers for subcontractor pricing proposals. However, the overall effectiveness of these audit services could be enhanced if deficiencies in cost and pricing data, contractor management systems, and defective pricing were reported

promptly to higher authority for resolution and appropriate management action.

Now we have begun a long series of subcontractor pricing audits, and we have 39 audits underway right now, Mr. Chairman. I've listed those in appendix 4 of my statement.

I want to illustrate for you what we found in one audit of contracting practices between the prime and the sub. Over half of the subcontractor procurement actions in 1983 had been awarded noncompetitively, without documented evidence of a market search of any kind. This occurred because the Government, without reviewing the prime contractor's subcontracting procedures, relied on prime contractors to obtain the most economical subcontract prices.

In our testimony in early 1983, we identified the need for more discipline in the negotiation process to ensure that prime contractors provide required analyses of subcontractor proposals; that contracting officers make effective use of field pricing audits; and that negotiation procedures are fully documented, as required by the Federal acquisition regulation. Such actions will provide assurance that DOD will negotiate fair and reasonable prices for major weapons systems.

The Deputy Secretary of Defense issued a memorandum in November 1983 that addressed a number of the problems that we had identified in this earlier work. We are in the process of seeing if those actions that he recommended be taken in November 1983 are now starting to take hold.

For example, are we giving our auditors adequate time to allow them to conduct a proper evaluation of the contractor's proposals? Are we, in fact, making sure that the contractor's estimating system is a formalized one and something that can be reviewed? Do his accounting systems properly accumulate costs?

We have the guidance out on the street. Now the question remains, is the guidance being followed? That is part of our role in the Inspector General's Office, to make sure that it is, in fact, happening. We intend to do this.

In conclusion, while some of those problems I have talked about today are widespread, I think they can be significantly alleviated by some changes in the Truth in Negotiations Act. We must make sure that that act is strengthened so that contractors are not rewarded for defective pricing, poor estimating, and inadequate prime contractor management of subcontracts.

As such, the Truth in Negotiations Act is the best means the Government has to prevent contractors from reaping unearned or excessive profits on contracts. I note that there are a number of bills that have been introduced which in one way or another represent attempts to reestablish the old Renegotiation Board. We believe that a strengthened Truth in Negotiations Act, supported by good, effective pricing audits, would be much more effective in eliminating excessive profits than any of the renegotiation proposals that we have seen.

Specific decisions of the Armed Services Board of Contract Appeals have weakened the original intent of the Truth in Negotiations Act. Therefore, we believe the act should be amended to restrict or eliminate the use of offsets when the contractor knowingly underpriced a portion of his proposal.

Also, we need to place a burden of proof on him equal to the burden of proof on the Government when he offers offsets. We need to require contractors to pay interest on defective pricing cases in order to reduce delays in settlement. We need to require that cost and pricing data be provided only to the contracting officer. Mr. Chairman, what I mean here is that from time to time, contractors claim that they have provided certain cost and pricing data to some agency within the Government. It has been ruled that if anyone in the Government has access to that cost and pricing data, that is as good as giving it to the contracting officer. Sometimes the contracting officer may not be aware it exists. That defense has to be eliminated.

There are some other defenses which we found the Board of Contract Appeals has approved over the years and we think need modification. One is that a contractor argues, "Well, I was in a sole-source bargaining position, and even if I had given you the correct data, I wouldn't have given you a better price."

That is the whole rationale for the Truth in Negotiations Act in the first place. Contractors have simply put the act on hold with that kind of an argument.

Another argument that is used: The price would not have been modified, because the contractor was in a superior bargaining position. Again, that is why we want the cost and pricing data, because the contractor is in a superior bargaining position.

Another defense is that the contracting officer should have known the data submitted were defective. Again, to me, that should not be a defense. We don't know how competent some of our contracting officers are. I think most of them are very competent. However it is a subjective issue whether he should or should not have known. The issue in my mind ought to be, was the data provided or was it not provided? If it was provided, was it accurate?

We've seen such defenses used as, "Well, this contract doesn't count because we sold it to a foreign government," or, "The contracting officer went to the bottom line and negotiated only the bottom line cost, and therefore it does not matter if we defectively priced some of the elements of expense up above the bottom line."

Finally, we ought to preclude contractors from the defense of not providing valid cost and pricing data on certified catalog or market pricing. If the certification is, in fact, not an accurate certification, then it seems to me the Government ought to have the option of taking the full Truth in Negotiations Act and applying it to the contract when the contractor certified that it was a commercial item and therefore not necessary to provide cost and pricing data.

In summary, I would like to state that my office intends to continue to test and check all facets of the procurement process. We will not condone overpricing by prime contractors or subcontractors. There are many problems that need to be addressed. Your hearings play an important role in calling attention to these problems, as well as seeking solutions.

There are other groups, such as the President's Blue Ribbon Commission on Defense Management, which [illegible] reviewing the DOD acquisition process. We know they will assist in addressing and resolving many of these longstanding problems.

That concludes my statement, Mr. Chairman. I'm sorry it was a little long. I wanted to make some of those points, because I'm not sure to what extent they are widely known.

I look forward to answering your questions.

[Mr. Vander Schaaf's prepared statement follows:]

STATEMENT BY

DEREK J. VANDER SCHAAF

DEPUTY INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Mr. Chairman and members of the Subcommittee.

I would like to thank you for this opportunity to appear today and discuss the problems we, in the Office of the Inspector General, have identified with audits of contractor data and with resolution and disposition of contract audit findings and to recommend for your consideration corrective legislation. The principal objective of my testimony this morning is to interest this committee in two pieces of needed legislation--legislation strengthening the Truth in Negotiations Act, Public Law 87-653 and Program Fraud Civil Penalties legislation. In recent years, interest in this legislation has centered in the Senate Government Affairs Committee. Our three years of experience under the Inspector General Act has continued to highlight the need for legislation in both these areas.

However, before I get into some of the details of this legislation, I would like to give you a little background. The Inspector General, Department of Defense, has a statutory responsibility not only to perform audits, but also to set policy for, and perform oversight of, the work of all DoD auditors. The DoD has 13 internal and contract audit organizations. In addition to the Defense Contract Audit Agency (DCAA), the largest audit organization, each of the Military Departments has its own internal audit organization, and there are several internal review organizations. Twelve of these 13 audit organizations are not a part of the Inspector General organization.

The Defense Contract Audit Agency provides contract audit and related accounting and financial advisory services to all Defense procurement and contract administration organizations. These services support the negotiation, administration and settlement of Defense contracts and subcontracts. For operational purposes, the DCAA is under the direction and control of the Assistant Secretary of Defense (Comptroller).

When the IG, DoD, was established, the Secretary of Defense was directed to transfer not less than 100 positions to the Inspector General and fill these positions with people trained to perform contract audits. These 100 auditors were not to be used to advise DoD contracting officers in the process of negotiating contracts. The Congress provided the IG with a contract audit capability to (1) provide the manpower and technical expertise to oversee and review the work of DCAA, and (2) provide the flexibility and resources needed for situations where the Inspector General thinks it necessary or appropriate to look at entire procurements--the performance of defense contractors, as well as the performance of defense personnel. These additional positions reinforced the ability of the Inspector General to break through the artificial barrier which previously existed between internal and contract auditing.

Contract Audit Policy and Oversight

Policies and procedures for Defense contract auditing are set out in directives, instructions and policy memoranda; the Defense Supplement to the Federal Acquisition Regulation; and the DCAA Audit Manual (which has been in existence for many years). Contract auditors must also follow the auditing standards issued by the American Institute of Certified Public Accountants and the Comptroller General of the United States, and comply with policies set forth in Office of Management and Budget Circular A-73.

Because of the extensive policy guidance already in place, we have focused our efforts on oversight of DCAA and issued only two additional contract audit policy memoranda to date. They covered DCAA's participation in "should cost" pricing reviews and coordination between contract and internal auditors.

The establishment of an Inspector General within DoD has led to a significant improvement in the coordination and transfer of knowledge between audit organizations. For example, our internal auditors have just completed an audit of the use of "should cost" reviews to support contract negotiations. In a should cost study a team of Government experts calculates what the item being purchased should cost. These data are then used by the contracting officer to assess the reasonableness of a contractor's proposal. The auditors concluded that the pay-off from "should cost" is substantial and recommended that the technique be used at least

once in the early production years of all major programs, despite the high cost of a thorough "should cost" review.

The primary purpose of oversight reviews is to monitor how well Defense auditors comply with established standards, policies and procedures when performing audit work. The auditing standards address such areas as qualifications and training of auditors, ability of auditors to perform independent and objective audits, planning of audits, documentation of audit work, and reporting of audit results. Our oversight reviews of DCAA have included access to contractors' records, reporting of fraud or illegal acts, adequacy of defective pricing audits, coverage of subcontractors' pricing proposals, and effectiveness of operations audits and mobile incurred cost audits (Appendix 1).

These oversight reviews and our experience with contract audit followup have helped us identify at least three areas which require more audit emphasis: defective pricing, contractor estimating systems, and subcontractor proposals. I believe greater audit emphasis in these three areas could bring about significant improvements in acquisition management within the Department of Defense.

DEFECTIVE PRICING

Public Law 87-653

The intent of Public Law 87-653, "Truth in Negotiations Act," is to give the Government informational parity with contractors and subcontractors during price negotiations so the Government can avoid excessive prices. Competition among defense contractors is limited in many procurements. The negotiation of the contract price in noncompetitive situations must be based on cost and price estimates. The contractor often has an advantage over the Government in these situations because he controls the cost or pricing data used to prepare the estimates. The Government sees only the cost or pricing data that the contractor provides during the negotiations. In passing the Act, Congress was seeking a remedy to place Government procurement officials on equal footing with contractors. By giving the Government the right to equal knowledge of all facts affecting contract price, Congress sought to ensure reasonable prices in negotiated contracts.

The provisions of the Truth in Negotiations Act are contained in 10 USC 2306(f). The Act requires that a contractor submit cost or pricing data to the Government and certify that, to the best of his knowledge and belief, the cost or pricing data was accurate, complete, and current at the time of submission. The certificate is required:

1. Prior to the award of any negotiated prime contract where the price is expected to exceed $100,000. The certificate does not apply to advertised contracts.

2. Prior to the pricing of any contract change or modification for which the price adjustment is expected to exceed $100,000, or a lesser amount as prescribed by the head of the agency. The certificate applies to all changes to prime contracts, whether negotiated or advertised.

3. Prior to the award of a subcontract at any tier, where the prime contractor and each higher tier subcontractor are required to furnish a certificate, if the price of the subcontract is expected to exceed $100,000.

4. Prior to the pricing of any contract change or modification to a subcontract covered by 3 above, for which the price adjustment is expected to exceed $100,000, or a lesser amount as prescribed by the head of the agency.

The threshold for certification was increased from $100,000 to $500,000 by Public Law 97-86 on December 1, 1981 because DoD officials testified that the Act placed an unnecessary paperwork burden on defense contractors. However, the Senate Committee on Governmental Affairs held hearings on defective pricing in 1983 and determined that there was not a sound basis for increasing the threshold to $500,000. The threshold for certification was

returned to $100,000 by Public Law 98-369, effective April 1, 1985. They also found that hundreds of millions of dollars were lost because adverse decisions by the Board of Contract Appeals and the courts had removed the "teeth" from the Truth in Negotiations Act.

The certificate of current cost or pricing data is not required in any of the following situations:

1. The contract price was based on adequate price competition. At least two bids were received and the contract was awarded solely on the basis of the lowest price.

2. The contract price was based on catalog or market prices of commercial items sold in substantial quantities to the general public.

3. The contract price was set by law or regulation.

4. The head of the agency waives the requirement for a certificate under exceptional circumstances.

Regardless of the presence of any or all of these conditions, the Government can still insist on submission of cost or pricing data and a certificate. My office has suggested that cost and pricing data be obtained in certain competitive situations. One such situation would be when two contractors are competing, but

the competition is more technical than price oriented. For example, two contractors may be offering a different technical solution to the same request for proposal, or one contractor may control a significant portion of anothers bid.

The Truth in Negotiations Act also requires that any prime contract meeting the criteria for certification must contain a price reduction clause. The clause permits the Government to reduce the contract price by the amount of increase caused by cost or pricing data that was not accurate, complete, or current.

The claim for exemption from submission of cost or pricing data because of catalog or market pricing of commercial items contains only a "representation" that the data provided is accurate. It does not contain an actual certification of accuracy, currency and completeness of the sales data furnished to substantiate the exemption.

We are in the final phase of an audit covering catalog and market pricing and have found that many of the claims for exemption cannot be substantiated. We have found indications of overpricing as a result. We will be recommending changes in the FAR to require more audit of such claims for exemption before and after award. However, we need specific language in our regulations that permit the application of the remedies provided in Public Law 87-653 when the contractor's representation of commerciality is found to be invalid even though the contracting

officer was or should have been aware that the items being purchased did not qualify for catalog or market pricing.

Federal Acquisition Regulation

Cost or pricing data include all facts, available at the time of negotiations, which prudent buyers and sellers would expect to have a significant effect on contract price. Cost or pricing data are factual and verifiable, not judgmental. Examples include vendor price quotations, purchase orders, historical costs, unit-cost trends, make-or-buy decisions, changes in production methods, and resource projections. Section 15.801 of the Federal Acquisition Regulation (FAR) defines cost or pricing data.

Cost or pricing data are submitted to the Department of Defense on the Contracting Pricing Cover Sheet. Along with that form, the contractor, or offeror if no contract award has yet been made, is required to provide a breakdown of proposed costs by element, disclose the basis for pricing elements of costs, and submit or identify supporting documentation such as vendor quotes or invoices. The contractor is also required to submit a certification of current cost and pricing data as soon as practicable after an agreement is reached on the contract or modification price. Subsection 15.804-4 of the FAR specifies the format and language for the certificate of current cost or pricing data.

Subsections 52.215-22 and 52.215.23 of the FAR give the Government a contractual right to a reduction in price when it is determined that certified data were not accurate, complete, and current. The clause at Subsection 52.215-22, "Price Reduction for Defective Cost or Pricing Data," must be included in solicitations and contracts when contracting officers contemplate requiring cost or pricing data. The clause at Subsection 52.215-23, "Price Reduction for Defective Cost or Pricing Data--Modifications," is required in solicitations and contracts when cost or pricing data will be required for the pricing of contract modifications and the clause at Subsection 52.215-22 has not been included.

The clause at Subsection 52.215-2, "Audit--Negotiation," should be inserted in all solicitations and contracts valued at more than $25,000. This clause gives the contracting officer or his representative the right to examine all books and records of the contractor in order to evaluate the accuracy, completeness, and currency of the cost or pricing data submitted in pricing the contract or any modification to the contract. The clause at Subsection 52.215-1, "Examination of Records by Comptroller General," should also be inserted in contracts valued at more than $25,000 to give the General Accounting Office (GAO) access to the contractor's books and records. This clause permits the GAO to examine the contractor's books and records for defective pricing.

Government Burden of Proof

Legal precedents have established that the Government must prove the following to recover in a defective pricing claim:

1. The contractor's cost or pricing data were inaccurate, incomplete, or noncurrent.

2. Accurate, complete, and current data were reasonably available to the contractor at the time of certification.

3. The Government did not have knowledge of the accurate, complete, and current data.

4. The Government relied on the defective data in negotiating the contract price.

5. Reliance on the defective data caused a increase in contract price.

Roles and Responsibilities

Defective pricing involves three key players. They are the contractor, contracting officer and contract auditor. A summary of the roles and responsibilities of each of these players follows:

Contractor

The contractor's responsibilities for submitting cost or pricing data are defined in Section 15-804 of the FAR. When the contractor is required to submit cost or pricing data and a certificate, the contractor is also required to obtain cost or pricing data and certificates from prospective subcontractors. Under most conditions, the prime contractor is not required to submit subcontractor data to the Government unless the Government specifically requests it. However, the contractor is required to submit subcontractor data to the Government when the estimated value of the subcontract is more than $1 million, or more than $100,000 and 10 percent of the prime contractor's proposed price.

The prime contractor is also responsible for evaluating the cost or pricing data submitted by its prospective subcontractors. The results of these evaluations are to be included in the prime contractor's own cost or pricing data submission. However, in some situations the prime contractor cannot evaluate the prospective subcontractor's cost or pricing data. This is especially common where the prime contractor and subcontractor are competing for the award of a contract or subcontract on a different program. The subcontractor may refuse to allow the prime contractor's auditors into his plant because he does not want to give the prime contractor access to his estimating methods and procedures. When this happens, the prime contractor is responsible for reporting

the condition to the contracting officer so that the Government auditors can perform the review.

If defective pricing is discovered on a subcontract after the prime contractor and the Government have agreed on the contract price, the prime contractor is liable to the Government for the amount of the defective pricing. The subcontractor is liable to the prime contractor. Therefore, the prime contractor often includes an indemnification clause in subcontracts.

Contracting Officer

The authority and responsibilities of the contracting officer are defined in Subpart 1.6 of the FAR. The FAR states that the contracting officer is the Government's only representative for entering into contracts. The Government is bound by the decisions of contracting officers if they act within the limits of the authority given to them by the FAR and Public Law. Subsection 1.602-2 of the FAR states:

> No contract shall be entered into unless the contracting officer ensures that all requirements of law, executive orders, regulations, and all other applicable procedures, including clearances and approvals, have been met.

In requesting a price proposal from a contractor, the contracting officer must prepare a "request for proposals." The request for proposals includes instructions on the preparation

of the price proposal and identifies the FAR clauses that will be included in the contract. The contracting officer must ensure that all clauses pertinent to Public Law 87-653 are included in the solicitation and contract.

In negotiating the contract price, the contracting officer has overall responsibility for the actions of the contractor. The contracting officer must ensure that the contractor submits certified cost or pricing data and obtains certified cost or pricing data from subcontractors, if required by Section 15.804 of the FAR. The contracting officer must then ensure that the cost or pricing data are adequately reviewed before negotiation of the contract price. The contracting officer is also responsible for obtaining assistance, if needed, from specialists in law, audit, engineering, and other fields before negotiating the contract price.

At the conclusion of the negotiations, the contracting officer is required to prepare a price negotiation memorandum and include it in the contract file. This memorandum must address the principal elements of the price proposal and explain the extent to which the contracting officer relied on the contractor's proposal in negotiating the contract price. If the contracting officer knew that any element of the cost or pricing data was inaccurate, incomplete, or noncurrent at the time of the negotiations, the memorandum must explain how the defective data were treated in establishing the contract price. The price negotiation memorandum

58-931 O—86——4

must include a summary of the contractor's proposal, the field pricing report recommendations, and the reasons for any disagreements with the field pricing report recommendations. The negotiation memorandum must also explain the basis for the contract profit or fee.

If an audit report was submitted to the contracting officer as part of the field pricing evaluation of the contractor's proposal, the contracting officer is required to provide a copy of the price negotiation memorandum to the auditor. The auditor reviews the price negotiation memorandum to identify any indication of potential defective pricing and to evaluate the overall effectiveness of the preaward audit.

The importance of the price negotiation memorandum cannot be overemphasized. The price negotiation memorandum is the Government's official record of what took place at the negotiations. If it is poorly written, the Government can only speculate as to what was provided by the contractor and what was relied on by the negotiators. The Government has lost several defective pricing cases in the past because of inadequate detail in the price negotiation memorandum. The contracting officer should prepare the price negotiation memorandum as soon after the completion of the negotiations as possible to help ensure its accuracy and completeness.

After the contracting officer receives an audit report on defective pricing, he or she normally weighs the evidence in the report against the information available from the contract file. If the auditor was not aware of additional data provided by the contractor during the negotiations, the contracting officer generally discusses the data with the auditor and requests that the audit report be corrected or withdrawn. If the contracting officer agrees with the auditor's recommendations, the contractor is provided with written notification of the allegation.

Subsection 15-804-7 of the FAR requires that the contracting officer consider three factors in seeking a price adjustment under Public Law 87-653. The contracting officer must consider the time by which the cost or pricing data became reasonably available to the contractor, the extent to which the Government relied on the defective data, and any understated cost or pricing data submitted by the contractor in the same pricing action which would offset the amount of the defective pricing reported by the auditor.

The contracting officer normally gives the contractor a period of 30 to 60 days to respond to the auditor's allegations in writing and to search for valid offsets (cost elements that were underpriced by the contractor in the same pricing action). After reviewing the contractor's rebuttal, the contracting officer may attempt to effect settlement with the contractor. If a settlement can be reached, a bilateral contract modification

will be issued to adjust the contract price downward by the amount of the settlement agreement. If the adjustment cannot be made from the funds remaining to be paid to the contractor, or if the contractor has already received the final payment on the contract, the contracting officer will require the contractor to reimburse the Government by check.

If the contracting officer and the contractor cannot reach a settlement agreement, the contracting officer will issue a final decision to the contractor. The final decision will include a unilateral contract modification for the amount of the defective pricing, and a demand for contractor payment if the contractor has already received the final payment. The contractor has 90 days to appeal the contracting officer's final decision to the Armed Services Board of Contract Appeals, and 12 months to appeal the decision to the U.S. Claims Court.

The contracting officer normally obtains legal advice before issuing a final decision on defective pricing. The legal advisor researches precedent cases, evaluates the risks associated with litigation, and recommends a course of action to the contracting officer. Regardless of the advice given, however, the contracting officer is the only person with the authority to issue a final decision.

Contract Auditor

Most of the reports issued by the DCAA involve reviews of contractor price proposals (prior to contract award) and reviews of costs incurred by contractors and billed to the Government. The Agency spends only a fraction of its time looking for cases of defective pricing. During the six months ended March 31, 1985, the DCAA issued 27,021 audit reports. Of the reports issued, 13,411 were issued as the result of reviews of contractor price proposals, 11,912 were issued as the result of reviews of incurred costs, and only 537 were issued as the result of defective pricing reviews. The defective pricing reports were less than about 2 percent of all reports issued during the period.

We, in the Inspector General, believe maintaining integrity in the procurement process is an important concern to the taxpayer. Because Public Law 87-653 is the key safeguard to maintaining integrity in the procurement process, we have devoted a lot of our oversight effort to evaluating the performance of defective pricing audits by the DCAA. Our Contract Audit Policy and Oversight group has performed three oversight reviews of DCAA's defective pricing program. These reviews addressed the quality of defective pricing reports, the quality of defective pricing reviews and the sustention rate on audit questioned costs relating to defective pricing.

The DCAA has steadily devoted more resources to this vital defective pricing audit area as more manhours become available through new hires. In FY 1983, defective pricing reviews comprised less than three percent of DCAA work load. They still comprise less than 6 percent of the DCAA audit effort. We support DCAA plans to increase the amount of effort devoted to defective pricing audits to 7.4 percent in DCAA management year 1986.

Problems the Inspector General Has Found in the Administration of the Truth in Negotiations Act

Quality of Reports

In our review of the quality of defective pricing audit reports, we found the DCAA reports generally were clear, convincing and adequately supported. However, we found 22 of the 216 reports contained descriptions of defective pricing situations which could possibly be an indication of fraudulent contractor actions. We sent the reports to the Defense Procurement Fraud Unit, who forwarded them to DCAA for their evaluation. After review, DCAA referred three of the contractors for criminal investigation. More recent data which we have obtained indicate that there has been a significant increase in the number of fraud referrals made by DCAA. We also identified 11 reports which contained qualifications on the scope of the audit work because the contractor denied the DCAA auditors access to needed records.

Quality of Reviews

When we evaluated the quality of the actual defective pricing reviews, we found that DCAA had extensive guidance on defective pricing, but it was not always followed. We found that (1) audit offices did not maintain a complete inventory of contracts; (2) lead sheets for selecting contracts with the highest probability of containing inaccurate cost or pricing data were not prepared and used; (3) lower priority audits were completed before defective pricing audits; (4) temporary duty assignments, rotation and overtime were not used to complete scheduled defective pricing reviews; and (5) insufficient audit evidence was tested to find defective pricing.

We concluded that DCAA needs to devote more attention to defective pricing reviews to be sure they are planned properly, and completed promptly and properly. The DCAA also needs to increase emphasis on training and supervision to enhance the effectiveness of DCAA defective pricing audits. I believe increased emphasis on defective pricing will help encourage contractors to improve their contract estimating systems and, thereby, help ensure that original proposals are accurate and reasonable. I will address contractor estimating systems in more detail later.

Sustention Rates for Defective Pricing Reviews

Last year we completed a review of the sustention rate for selected defective pricing audit reports issued by DCAA. Our analysis indicated DCAA was sustained on only 38 percent of their recommendations, rather than the 60 percent sustention rate they reported. The major reason for the difference in the sustention rates was the way DCAA reported cases when the contractor appealed a contracting officer's unilateral decision. Although the DCAA considered the contracting officer determination as a 100 percent sustention, we think there is no sustention unless a contract modification or payback of monies occurs. We have reached an agreement with DCAA that they will caveat the net savings figures reported outside of DCAA and indicate the amount of net savings reported that is in the appeals process.

More recent reviews and other analyses by my staff continue to show that the DoD components and DCAA are reporting vastly different amounts and rates for the sustention of contract audit findings in general. However, the differences in reported sustention rates for defective pricing audits in particular have been largely eliminated as a result of our long standing interest in defective pricing audits. We do, however, remain concerned over the relatively low sustention rates achieved in defective pricing.

During the latest semiannual reporting period which ended in March 1985, the sustention rate for defective pricing audits, 31.4 percent, was well below the 50.4 percent overall rate for all types of reports. The poor sustention rate for defective pricing audits was due in large part to the low sustention rate of 12.4 percent reported by the Navy. My Contract Audit Followup staff is currently reviewing the cases closed by the Navy to determine what happened.

Appendix 2 displays sustention statistics for defective pricing audits by individual DoD components for the past three reporting periods. Our field contract audit followup reviews, conducted over the past three years, have given us a better understanding of the problems which prevent timely closing of defective pricing reports and contribute to the low sustention rates. Appendix 3 provides a listing of contract audit followup reviews conducted during FY 1984 and 1985. Problems we have found include:

o Lack of communication and cooperation between contracting officers and DCAA auditors.

o Inadequate price negotiation memoranda which lack the specific comments required by the FAR on the extent of reliance on cost and pricing data.

o Competing demands for contracting officer's and auditor's time, primarily assigning priority to preaward and forward pricing audits at the expense of defective pricing reviews.

o Failure of DoD managers to reallocate resources to enable timely resolution and disposition of defective pricing audits. For example, we recently found eight defective pricing audit reports which had been sitting in a Navy Office of Counsel for over a year awaiting legal reviews.

o Failure of DoD management to challenge proposed dispositions elevated to them for review and recommendations.

o Inexperience and lack of training of contracting officers assigned to processing defective pricing audits.

o Unwillingness of contractors to cooperate and respond to contracting officer's requests for information on audit findings, particularly for defective pricing.

o Lack of timely DCAA review of contractor rebuttals (offsets, etc.) on defective pricing audits.

o Reluctance of DCAA auditors to elevate such problems as:

- Nonreceipt of price negotiation memoranda.

- Misstatements in price negotiation memoranda regarding auditor agreement on negotiation position.

- Lack of explanation in price negotiation memoranda regarding differences between the proposed disposition originally agreed to by the auditor and the actual disposition.

- Dispositions that are adverse to the interests of the Government.

o Inaccurate reporting.

Our reports to the components as a result of the reviews have included a number of recommendations to help improve the resolution and disposition of defective pricing contract audits. Some of those recommendations are:

o Discontinue settlements that waive the rights of the Government for future defective pricing claims on contracts.

o Obtain timely, written legal reviews of all defective pricing cases as soon as contractors are given adequate opportunities to respond to audit findings.

o Assign a dedicated staff to resolve and dispose of defective pricing reports at major buying activities. (This has been done at Warner-Robins Air Logistics Center and at Aeronautical Systems Division, Wright-Patterson Air Force Base.)

o Give full consideration to the audit report recommendations and request that auditors attend negotiations when warranted by the dollar amounts and nature of items in question.

o Establish milestones for achieving resolution and disposition of contract audit reports including firm turnaround times for contractor and advisor responses.

o Ensure that the settlement of defective pricing cases results in downward price adjustments to the contracts under which the defective pricing actually occurred.

o Prohibit the acceptance of additional or future goods or services as settlement for the identified defective pricing.

o Obtain advice and review by a designated independent senior acquisition official, if necessary, and make all contract decisions as soon as adequate information is available.

In addition to the recommendations we have made to the DoD acquisition officials, we are revising our directive DoD 7640.2,

BEST COPY AVAILABLE

"Policy for Followup on Contract Audit Reports," to expand the requirements for DCAA auditor elevation of specific differences with contracting officer actions to contract audit followup officials and the Assistant Inspector General for Audit Followup.

Although we have seen some improvement at specific locations, many of the listed problems still exist. The key to solving these problems is increased interest by top level managers and the expression of that interest to their staff and especially to industry. Active management involvement and support of contracting officers and auditors will demonstrate to industry that DoD takes defective pricing very seriously and that we expect cooperation from contractors as a condition for doing business with DoD.

Program Fraud Civil Penalties Legislation

As you might expect we frequently encounter cases of false statements when we do defective pricing audits. We continue to support, as we have in the past two Congresses, the establishment of an administrative penalty mechanism to address false claims and false statements to the Department of Defense. The Secretary of Defense has supported the development and aggressive use of civil, administrative and contractual remedies for fraud in conjunction with, or in lieu of, criminal prosecution.

Traditionally, criminal prosecution has been treated as the primary weapon against fraud, and in many instances, as a precursor to any other action. This has sometimes led to the practice that when prosecution was declined, there was no subsequent attempt to seek administrative action to punish offenders, protect the Government and recover funds lost through fraud. This practice seems to favor a one shot remedy, the criminal case, at the expense of any other related efforts.

We in the DoD have, through a number of efforts, attempted to stop this practice, and improve the way we address fraud in our programs. Our efforts have been directed at achieving a coordinated approach to the investigation of fraud and the timely imposition of appropriate remedies for fraud available to us. We have taken several decisive steps in this area:

o We have prepared a DoD directive requiring the establishment of a single authority in each Military Department and Defense Agency to monitor fraud investigations and to coordinate criminal, civil, administrative and contractual remedies for fraud.

o We have encouraged simultaneous civil and criminal referrals of fraud cases to the Department of Justice.

o We have designed and presented a fraud training program for auditors, investigators and attorneys. This program

familiarizes the participants with DoD contracting procedures, fraud investigative techniques, and relationships with the Department of Justice. Further, the program describes and stresses the need for coordinated application of administrative, civil, contractual, and criminal remedies for fraud. We have now presented this program 16 times with over 650 attendees.

o Increased efforts have been made in providing fraud awareness training to program officials, particularly people assigned to procurement responsibilities. During the last two years, my office and the military criminal investigative orgarizations have made approximately 6,800 fraud awareness presentations to over 255,000 attendees worldwide. These briefings stress improved recognition of potential fraud and more effective use of available remedies.

Each of these efforts has yielded improvement in the use of existing remedies for fraud. They have also clearly shown us that additional remedies are needed, which is why program fraud civil penalties legislation is so important. Legislation in this area would provide a mechanism for an appropriate Government response to instances of fraud that occur, but are not now addressed by the Government for a variety of reasons.

Many of the cases referred to the Department of Justice by DoD are declined for prosecution. Many of these cases clearly involve fraud. However, there are many reasons for not prosecuting

these cases, including the evidentiary standard required to prove criminal violations, as well as other priorities to which the Department of Justice must devote its resources.

In making these resource allocation determinations, one criteria which is used is the dollar value of the loss to the Government in the case. Therefore, some United States Attorneys have established thresholds below which fraud cases absent special circumstances will generally not be accepted for prosecution. While the Department of Justice is clearly responsible for such prosecution decisions, the integrity of DoD programs must ultimately be the responsibility of the Department of Defense. Accordingly, I believe it is necessary to have a procedure within the Department of Defense to appropriately address those instances of fraud which the Department of Justice does not prosecute, but which clearly impact upon the integrity of our programs.

There are several examples illustrating the need for a civil penalty authority, particularly in the procurement fraud area, which is the primary area of interest for my office. An administrative penalty mechanism could have been used in the following closed cases.

o Based on a General Accounting Office (GAO) report, a Department of Justice and Naval Investigative Service investigation identified over $600,000 in fraudulent overpayments on a base maintenance contract in the Norfolk, Virginia, area. The contractor

was found to have deliberately overbilled the Navy on numerous items. Because of evidentiary problems, a decision was made to seek criminal prosecution on only $25,000 in false claims. Subsequently, the Department of Justice determined that $25,000 was too small an amount to justify prosecution, and the case was declined for both criminal and civil action. An administrative penalty in this case could have facilitated a recovery of a substantial loss.

o A contractor engaged in a conspiracy with a DoD contracting officer in order to be awarded a DoD contract. The contracting officer falsified the need for a sole source procurement and, in collusion with the contractor, allowed the contractor to write the Government's sole source justification for the award. While prosecution was declined, in part because DoD discovered the scheme before the actual award of the contract and before there was a dollar loss to the Government, a conspiracy to defraud was clearly evident. Again, an administrative penalty would have been appropriate to punish this attack on the integrity of the procurement process.

o A contractor operated a parts store on 10 different military bases. He illegally inflated parts prices on each contract. While the total fraud amounted to over $50,000, no single base was defrauded for more than $6,000. Each case was presented to nine separate United States Attorneys, and was declined at each office because the dollar value was too low.

Our ongoing defective pricing audits have resulted in six cases being referred to the Department of Justice for possible prosecution. While some of these cases may eventually result in prosecution because of the large dollar amounts involved in the case as a whole. Based upon my experience, others will be declined because of the relatively small amounts involved with each specific violation.

An administrative penalty mechanism will protect the right to a fair and reasonable hearing for any person alleged to be liable and provide adequate due process for all parties concerned. The knowledge standard--"knows or has reason to know"--is an appropriate one for a finding of liability under any legislation enacted in this area. The "general intent" standard should be used in lieu of "specific intent" to defraud in order to make a finding of liability. This general intent standard has general acceptability in civil cases litigated under the False Claims Act and in administrative matters. I should add that Federal agencies should not be permitted to proceed administratively unless the Justice Department has specifically declined prosecution under the False Claims Act or the False Statements Statute, and approved further proceedings.

Legislation in this area should include penalties for false statements, as well as false claims. This is important in the contract fraud area, especially when a contractor falsely makes a variety of certifications, such as:

- a certification of small business size status;
- a certification of minority status;
- a certification regarding allowability of overhead costs;
- a certification regarding the completeness and accuracy of cost and pricing data;
- a certification of commerciality in order to obtain waivers of cost and pricing data.

These certifications are usually accepted at face value and are rarely questioned because much of the Federal contracting process relies upon the integrity of contractors to accurately provide such information. When a false certification is discovered, it undermines this essential relationship. These cases are rarely prosecuted, and unlike false claims, there is no civil statutory remedy for false statements.

I believe that an administrative penalty mechanism for false claims and statements will provide an important weapon to the Department of Defense, as similar provisions have already been of great assistance to the Department of Health and Human Services (HHS) in their campaign against fraud. It is ironic that HHS has had this authority to combat fraud in health programs, but the Department of Defense has not had this authority to deal with fraud on Defense contracts.

AUDITS OF ESTIMATING SYSTEMS

We feel that quality contractor estimating systems are the essential element to assure that contracts are awarded based on current, complete and accurate information. Therefore, we are currently conducting an oversight review of DCAA coverage of contractor's estimating practices. The objective of our oversight review is to determine the adequacy of DCAA evaluations of contractor cost estimating systems and the adequacy of DCAA reporting and follow up on contract cost estimating weaknesses.

Although we are only in the survey phase of our review, we have found instances where the auditors have repeatedly reported estimating system deficiencies to contracting officers with no action being taken to correct the problem. We have discussed this with the contracting officers and they stated that they do not have the leverage to make the contractor correct the problem. I have a problem with their responses.

Reviews of the accuracy and currency of the data in contractors' estimating systems are vital to assuring proposals are current, complete and accurate. Estimating systems need to be reviewed as systems--not in pieces as parts of reviews of individual proposals. It is only when reviewed in their totality that conclusions can be reached as to their overall correctness. It is only through a systems review that patterns of how contractors treat certain kinds of costs emerge.

For example, if the contractor's estimating system is found to have a pattern of overestimating engineering costs, the defect in the estimating system needs to be corrected. This should be done as part of a review of the estimating system, as opposed to attempting to correct for erroneous estimates when evaluating the individual proposals which the estimating system produces. Furthermore, a pattern of overestimation of engineering costs may not be apparent in evaluating individual proposals when a great number of proposed costs must be reviewed in a short time. An audit of the system to ensure it produces current, complete and accurate data would be better than just checking the proposed amount to be sure it was produced from the audited systems. A systems audit approach corrects the data before it enters the proposal.

While we emphasize the importance of estimating system reviews to produce current, complete and accurate cost and pricing data, we must also be diligent in testing the data through an aggressive program for performing defective pricing audits. When these audits demonstrate that the estimating system is producing defective data, aggressive corrective actions must be taken. It is not enough just to issue defective pricing reports and ignore the root cause of the defect.

AUDITS AND OTHER EVALUATIONS OF MAJOR SUBCONTRACTORS' PRICING PROPOSALS

In an oversight review of DCAA, we found that subcontractors' pricing proposals were not always properly analyzed either by prime contractors or by Government audit and technical agencies. Furthermore, when subcontractors' pricing proposals were analyzed, the results were not always given appropriate consideration when negotiating prime contract prices.

Generally, we found the DoD internal audit agencies placed very little emphasis on evaluating subcontract management areas, such as negotiation of contract prices for subcontracts. The DCAA generally provided timely, quality audit assistance to DoD contracting officers for subcontractors' pricing proposals. However, the overall effectiveness of these audit services could be enhanced if deficiencies in cost and pricing data, contractor management systems, and defective pricing were reported promptly to higher authorities for resolution and appropriate management action.

My Assistant Inspector General for Auditing has substantially increased audit coverage in the area of subcontracting. For instance, in our review of the Sergeant York Air Defense Gun System, we found that the Army would have paid as much as $84 million more than necessary because the prime contractor, in part, had not devoted adequate attention to field pricing reviews of its major subcontractors' proposed prices.

Since that audit, we have initiated 39 additional audits involving the area of subcontracting, of which 38 are still in process (Appendix 4). During these audits, our auditors have disclosed potential subcontracting deficiencies in the areas of defective pricing, competition, and cost and pricing data. For example, during our reviews of contracting pricing, we have found numerous examples of defective pricing involving subcontractors that could result in the Government paying millions of dollars more than necessary. In another audit, we found that over half of the subcontractor procurement actions for FY 1983 had been awarded noncompetitively without documented evidence of market searches. This occurred because the Government, without reviewing the prime contractor's subcontracting procedures, relied on prime contractors to obtain the most economic subcontract prices.

The Inspector General will continue to place emphasis in the area of subcontracting. In fact, we have over twelve audits involving subcontracting plannted to start in FY 1986. In our planned efforts, we will concentrate on the areas of defective pricing, competition, and subcontract management responsibilities of prime contractors.

In our testimony in early 1983, we identified the need for more discipline in the negotiation process to ensure that prime contractors provide required analyses of subcontractor proposals; contracting officers make effective use of field pricing audits; and negotiation proceedings are fully documented as required by

the Federal Acquisition Regulation. Such actions will provide assurance that DoD will negotiate fair and reasonable prices for major weapon systems contracts.

The Department has taken action to require DoD contractors to establish and maintain adequate estimating, purchasing and cost accounting systems. The Deputy Secretary of Defense issued a memorandum on November 3, 1983, which directed the Services to reemphasize the following policies:

o That adequate time be provided to allow for a proper evaluation of the contractor's proposal.

o That contractor estimating systems be formalized and follow sound estimating procedures.

o That contractor accounting systems properly accumulate costs for historical purposes.

o That contractor purchasing systems be fully adequate.

o That contractor proposal provides for adequate negotiations.

o That contractors' make-or-buy programs be reviewed and incorporated into the contract under the circumstances described in the Defense Acquisition Regulation.

BEST COPY AVAILABLE

o That a pre-negotiation price objective be established for negotiated procurements prior to the start of contract negotiations.

We are confident that the actions directed by the Deputy Secretary, if fully implemented, will correct the deficiencies in subcontractor pricing. We will continue to pay close attention to this area to assure his policies are carried out effectively by the Services.

CONCLUSION

While some of these problems are widespread, we believe they could be alleviated significantly if the Truth in Negotiations Act, Public Law 87-653, were strengthened to ensure contractors are not rewarded for defective pricing, poor estimating, and inadequate contractor management systems on subcontracting. The Truth in Negotiations Act was supposed to put the Government on an equal footing with contractors when negotiating contracts. The Act requires contractors to provide accurate and up-to-date information on contract proposals, which can help the Government obtain fair and reasonable prices. In a sense, the Act was designed to substitute for the lack of competition on Government contracts. As such, the Truth in Negotiations Act is the best means the Government has to prevent contractors from reaping unearned and excessive profits on contracts.

I note that a number of bills have been introduced which in one way or another represent attempts to reestablish the old renegotiation board. We believe that a stregnthened Truth in Negotiations Act, supported by good defective pricing audits, would be much more effective in eliminating excessive profits than any of the renegotiation proposals.

Specific decisions of the Armed Services Board of Contract Appeals have weakened the original intent of the Truth in Negotiations Act. Therefore, we believe that the Act should be amended to:

1. Restrict or eliminate offsets when the contractor knowingly underpriced a portion of his proposal. Also, limit offsets to that portion of the contract where defective pricing was identified.

2. Require contractors to pay interest on defective pricing cases to reduce settlement delays.

3. Require cost and pricing data to be provided only to the contracting officer, or his negotiating representative, i.e., prohibit contractors from providing cost and pricing data to Federal employees not involved in contract negotiations in lieu of the contracting officer.

4. Exclude defenses for submission of defective cost or pricing data based on:

a. The price would not have been modified because the contractor was in a sole-source bargaining position.

b. The price would not have been modified because the contractor was in a superior bargaining position.

c. The contracting officer should have known the data submitted were defective.

d. The contract was for sale to a foreign government.

e. The contracting officer negotiated only the bottom line (total cost) of the contract.

5. Provide the certification and price adjustment when it is discovered that the contractor's claim for exemption from submission of certified cost or pricing data on the basis of catalog or market pricing was inaccurate, incomplete or noncurrent.

SUMMARY

In summary, I would like to state that the Office of the Inspector General will continue to test and check all facets of the procurement process. We will not condone overpricing of

prime contracts or subcontracts. There are many problems that need to be addressed and your hearings play an important role in calling attention to these problems, as well as seeking solutions. Other groups, such as the President's Blue Ribbon Commission on Defense Management which is reviewing the DoD acquisition process, will assist in addressing and resolving long-standing problems.

We, in the Inspector General's Office, will not stand still and watch what happens. We will be an active participant in ensuring that effective systems and procedures are in place to assure that contracts and subcontracts are awarded properly and at a reasonable price. We will test the adequacy of those systems and procedures by continuing to examine selected acquisitions from requirement to delivery.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions which you or any member of the Subcommittee may have.

CONTRACT AUDIT POLICY AND OVERSIGHT REPORTS

APO 85-017	Report on the Review of the Audit Coverage at "NO ADV" Contractors by the Defense Contract Audit Agency
APO 85-016	Followup Review of the Defense Contract Audit Agency's Reporting of Fraud of Illegal Acts
APO 85-015	Report on Oversight Review of the Quality and Selection of Defective Pricing Reviews
APO 85-008	Report on Oversight Review of Mobile Incurred Cost Audits
APO 85-007	Review of the Defense Contract Audit Agency's Operations Audit Program
APO 85-003	Report on Oversight Review of Savings Reported in the Management Information System of the Defense Contract Audit Agency
APO 85-002	Review of Sustention Rate for Selected Defective Pricing Audit Reports
APO 85-001	Review of the Quality of Defective Pricing Audit Reports
APO 84-13	Report on DoD Hotline Allegation of Contract Overpricing, KAMAN Aerospace Corporation, Bloomfield, CT
APO 84-8	Oversight Survey of Reimbursable Billings
APO 84-5	Report on Oversight Review of the Defense Contract Audit Agency Access to Contractor Records
APO 84-4	Report on Oversight Review of the Defense Contract Audit Agency Reporting of Fraud or Illegal Acts
APO 84-3	Report on the Review of Audits and Other Evaluations of Major Subcontractors' Pricing Proposals
APO 83-2	Report on Pricing Reviews for the F-100 Engine Contract

DEFECTIVE PRICING

COSTS QUESTIONED/COSTS SUSTAINED BY DOD COMPONENT

MARCH 1984

ACTIVITY	NO. RPTS.	COSTS QUESTIONED ($000)	COSTS SUSTAINED ($000)	PERCENT
ARMY	29	$6,892	$2,648	38.3
NAVY	51	$28,753	$7,982	27.8
AIR FORCE	42	$18,771	$4,365	23.3
DLA	6	$3,922	$3,493	86.8
TOTALS	128	$58,338	$18,390	32.0

SEPT. 1984

ACTIVITY	NO. RPTS.	COSTS QUESTIONED ($000)	COSTS SUSTAINED ($000)	PERCENT
ARMY	43	$18,419	$5,459	52.4
NAVY	25	$29,921	$7,394	36.9
AIR FORCE	59	$17,622	$7,422	42.1
DLA	11	$684	$484	59.1
TOTALS	138	$48,746	$20,679	42.4

MARCH 1985

ACTIVITY	NO. RPTS.	COSTS QUESTIONED ($000)	COSTS SUSTAINED ($000)	PERCENT
ARMY	11	$18,972	$7,383	40.9
NAVY	63	$26,916	$3,358	12.4
AIR FORCE	74	$29,567	$9,988	48.2
DLA	4	$378	$77	20.8
TOTALS	152	$65,925	$29,718	31.4

APPENDIX 2

CAF Trips to Army Locations
FY 1984 and 1985

FY 1984

Jan	MICOM	Huntsville, AL
	COE	Huntsville, AL
	TACOM	Warren, MI
Feb	TECOM	Aberdeen, MD
	ARPRO Boeing Vertol Co.	Philadelphia, PA
	AARDC	Dover, NJ
Mar	COE	Portland, OR
	COE	St. Paul, MN
	FORCCOM	Ft. Sheridan, IL
	COE	Sacramento, CA
	ARPRO Hughes Helicopter	Culver City, CA
Jun	MRDC	Ft. Detrick, MD
	COE	Baltimore, MD
	Belvoir R&D Center	Ft. Belvoir, VA
	AAMCOM	Rock Island, IL
	COE	St. Louis, MO
	TROSCOM	St. Louis, MO
	AVSCOM	St. Louis, MO
Jul	CECOM	Ft. Monmouth, NJ
	ARPRO Boeing Vertol	Philadelphia, PA
	COE	Philadelphia, PA
	MICOM	Huntsville, AL
Aug	TACOM	Warren, MI
Sep	LATP	Lima, OH

APPENDIX 3

CAF Trips to Army Locations
FY 1984 and 1985

FY 1985

Jan	AVSCOM	St. Louis, MO
	COE	Louisville, KY
	COE	Sacramento, CA
	ARPRO Bell Hellicopter	Ft. Worth, TX
Feb	COE	Ft. Worth, TX
Mar	TACOM	Warren, MI
Apr	AAMCOM	Rock Island, IL
Jun	COE	Winchester, VA

Planned-Remainder of FY 1985

Sep	AVSCOM	St. Louis, MO

CAF Trips to Navy Locations
FY 1984 - FY 1985

FY 1984

Dec	NAVSUP	Arlington, VA
	SPCC	Mechanicsburg, PA
	SUPSHIP	Charleston, SC
Jan	NAVPAC	Arlington, VA
	JCMP	Arlington, VA
	CACO-General Dynamics	St. Louis, MO
	SUPSHIP	Seattle, WA
Mar	SUPSHIP	Groton, CT
Apr	NAVSEA	Arlington, VA
	NAVPRO	St. Louis, MO
May	CACO-McDonnell Douglas	St. Louis, MO
Jul	NAVPRO-FMC	Minneapolis, MN
	NRCC	Philadelphia, PA
	NAVFAC	Arlington, VA
	ASO	Philadelphia, PA
Aug	NAVPRO-Sikorsky	Stratford, CT
	NAVAIR	Arlington, VA
	NAVELEX	Arlington, VA
	Military Sealift Command	Washington, DC
Sep	SUPSHIP	Bath, ME
	NAVPRO-Lynn-General Electric	Lynn, MA

CAF Trips to Navy Locations
FY 1984 - FY 1985

FY 1985

Oct	ONR	Washington, DC
Jan	Naval Training Equipment Ctr	Orlando, FL
	NAVSEA	Arlington, VA
Feb	NAVPRO-Bethpage-Grumman	Long Island, NY
	NAVPRO-Great Neck-Sperry	Long Island, NY
	NAVPRO-Vought	Dallas, TX
Mar	NAVPRO-Magna-Hercules	Magna, UT
	SUPSHIP	Seattle, WA
	NAVPRO	Pascagula, MI
	SUPSHIP	New Orleans, LA
	SUPSHIP	San Francisco, CA
Jun	NAVAIR	Arlington, VA
Jul	NAVSEA	Arlington, VA
	JMCP	Arlington, VA
	ONR	Washington, DC
	ASO	Philadelphia, PA
Aug	NRCC	Washington, DC
	NAVPAC	Philadelphia, PA
	NRCC	Philadelphia, PA
	NAVPAC	Norfolk, VA
	NAVSUP-Hq	Arlington, VA

Planned-Remainder of FY 1985

Sep	NAVPRO-Pomona-General Dynamics	Pomona, CA
	NAVPRO-Burbank-Lockheed	Burbank, CA
	NRCC	Washington, DC
	NAVPRO-FMC	Minneapolis, MN
	CACO-General Dynamics	St. Louis, MO

CAF Trips to Air Force Locations
FY 1984 and 1985

FY 1984

Jan	AD	Eglin AFB, FL
	HQ AFSC	Andrews AFB, MD
	ESD	Hanscom AFB, MA
	OC ALC	Tinker AFB, OK
	AFPRO Pratt & Whitney	W. Palm Beach, FL
	ASD	Wright Pat AFB, OH
Mar	AFPRO General Dynamics	Ft. Worth, TX
	AFPRO General Electric Co.	Kg of Prussia, PA
	OO ALC	Hill AFB, UT
	AFPRO Boeing Military Airplane Co.	Wichita, KS
	AFPRO Martin Marietta	Denver, CO
	WR ALC	Robins AFB, GA
	SM ALC	McCellan AFB, CA
	CACO Hughes Aircraft	El Segundo, CA
	AFPRO Rockwell International	Canoga Park, CA
	AFPRO Northrop	Hawthorne, CA
	AFPRO Aerojet General	Sacramento, CA
Apr	AFPRO Lockheed - Georgia	Marietta, GA
Jun	AFPRO Pratt & Whitney - EH	East Hartford, CT
	CACO United Technologies, Inc.	Hartford, CT
Jul	AFPRO Eaton Corp, AIL Div	Deer Park, NY
	AFPRO Chemical Systems Div	San Jose, CA
	CACO Boeing Company	Seattle, WA
Aug	SA ALC	Kelly AFB, TX
Sep	CACO Hughes Aircraft	El Segundo, CA
	SD	Los Angeles, CA
	CACO Lockheed	Burbank, CA
	BMO	Norton AFB, CA

CAF Trips to Air Force Locations
FY 1984 and 1985

FY 1985

Oct	OC ALC	Tinker AFB, OK
	ESD	Hanscom AFB, MA
Nov	AFPRO Pratt & Whitney	West Palm Beach, FL
Jan	AFPRO General Dynamics	Ft. Worth, TX
	AFPRO Aerojet General	Sacramento, CA
	SM ALC	McClellan AFB, CA
	CACO McDonnell Douglas	St. Louis, MO
Feb	AFPRO Boeing	Seattle, WA
	CACO Boeing	Seattle, WA
	CMD	Albuquerque, NM
	AFPRO Eaton Corp, AIL Div	Deer Park, NY
Mar	ASD	Wright Pat AFB, OH
Apr	WR ALC	Robins AFB, GA
	AFPRO Lockheed - Georgia	Marietta, GA

CAF Trips to Defense Logistics Agency Locations
FY 1984 - 1985

FY 1984

Oct	DCASR	Atlanta, GA
	DCASMA	Orlanda, FL
Jan	DCASR	Atlanta, GA
	DCASMA	Atlanta, GA
	DCASMA	Birmingham, AL
	DCASMA	Orlando, FL
	DCASPRO-AT&T	Burlington, NC
	DCASR	Boston, MA
	DCASMA	Boston, MA
	DCASPRO-Harris	Syosett, NY
	DCASR	Dallas, TX
	DCASMA	Dallas, TX
	DCASMA	San Antonio, TX
Feb	DCASPRO-Raytheon	Burlington, MA
	DCASR	Philadelphia, PA
	DCASMA	Philadelphia, PA
	DCASMA	Baltimore, MD
Mar	DCASR	Cleveland, OH
	DCASMA	Cleveland, OH
	DCASMA	Detroit, MI
Apr	DCASR	St. Louis, MO
	DCASMA	St. Louis, MO
	DCASMA	Inglewood, CA
	DCASMA	Santa Ana, CA
Jul	DCASMA	Hartford, CT
	DCASMA-Residency, Hamilton Std	Hartford, CT
	DCASPRO-AVCO	Stratford, CT
	DCASPRO-Honeywell	Minneapolis, MN
	DCASMA	Denver, CO
	Defense Personnel Support Ctr	Philadelphia, PA
Aug	DCASR	Cleveland, OH
	DCASPRO-Gould	Cleveland, OH
	DCASPRO-Goodyear	Akron, OH
	DCASMA	Pittsburg, PA

CAF Trips to Defense Logistics Agency Locations
FY 1984 - 1985

FY 1985

Dec	DCASR	Chicago, IL
	DCASMA	Chicago, IL
	DCASPRO-Sunstrand	Rockford, IL
Jan	DCASMA	San Diego, CA
	DCASPRO-FMC	San Jose, CA
	DCASPRO-Westinghouse	Sunnyvale, CA
	DCASMA	San Francisco, CA
Feb	DCASPRO-Michoud	New Orleans, LA
	DCASMA	Orlando, FL
	DCASPRO-Martin Marietta	Orlando, FL
	DCASMA	New Orleans, LA
	DCASPRO-General Dynamics	San Diego, CA
Mar	DCASMA	Springfield, NJ
	DCASPRO-IT&T	Nutley, NJ
	DCASPRO-Singer	Little Falls, NJ
	Defense Electronics Supply Ctr	Dayton, OH
Apr	DCASR	Boston, MA
	DCASMA	Boston, MA
	DCASMA	Dayton, OH
	DCASMA	Phoenix, AZ
	DCASPRO-McDonnell Douglas	Tulsa, OK
Jul	DCASMA	Detroit, MI
	DCASPRO-Teledyne	Toledo, OH
	DCASMA	Indianapolis, IN
	DCASMA-Residency, AM General	South Bend, IN
	DCASMA-Residency, Bendix	South Bend, IN
	DCASPRO-Magnavox	Fort Wayne, IN
	DCASPRO-GMC Detroit Diesel	Indianapolis, IN
	DCASPRO-Litton	Woodland Hills, CA
	DCASMA	Van Nuys, CA
Aug	DCASR	New York, NY
	DCASMA	New York, NY
	DCASPRO-Bendix	Teterboro, NJ
Sep	DCASPRO-AT&T	Burlington, NC
	DCASR	Dallas, TX
	DCASPRO-Texas Instruments	Dallas, TX

Planned-Remainder of FY 1985

Sep	DCASMA	Syracuse, NY
	DCASMA	Buffalo, NY
	DCASMA	Seattle, WA

OFFICE OF THE ASSISTANT INSPECTOR GENERAL FOR AUDITING

AUDITS INVOLVING SUBCONTRACTING

FY 1984 AND 1985

	TITLE	PROJECT NO.
PAST		
1.	SGT York Division Air Defense (DIVAD) Gun System (Report No. 84-126)	3MB-105
2.	Pricing of Contract DLA400-83-C-0814 Mine Safety Appliances Co. (Report No. 85-096)	4CB-095
IN PROCESS		
1.	Acquisition of the HARPOON Weapon System	5MD-091
2.	Acquisition of Landing Craft Air Cushion Vehicles	5MC-090
3.	AH-64 Advance Attack Helicopter (APACHE)	5MB-071
4.	Acquisition of Military Strategic Tactical and Relay (MILSTAR) Satellites	5MD-067
5.	NAVSTAR Global Positioning System Ground Terminals	5MC-059
6.	AGM-130 Air-to-Ground Guided Missile Program	5MA-057
7.	Defense Support Program	5MD-054
8.	Procurement of the Defense Satellite Communications System - Phase III Satellite	5MD-032
9.	Management of the Joint Cruise Missile Project	4MC-118
10.	Procurement Procedures for Trident Submarines	5MC-115
11.	Acquisition Procedures and Practices Involving the High Mobility Multi-Purpose Wheeled Vehicle (HMMWV)	4MB-114
12.	Acquisition and Modification of the P-3C Aircraft	5MA-002
13.	Competition In Subcontracting	4CC-044

	TITLE	PROJECT NO.
14.	DoD Should-Cost Program	4CD-047
15.	Pricing of Purchase Order 744350, Prime Contract DAAJ09-82-C-A326 at Rosemount Inc.	4CB-095
16.	Pricing of Purchase Orders E30016 and E30067, Prime Contract N00019-83-C-0272 at Rosemount Inc.	4CB-095
17.	Pricing of Purchase Order E30016, Prime Contract N00019-83-C-0431 at Rosemount Inc.	5CB-905
18.	Pricing of Purchase Order E30061, Prime Contract N00019-83-C-0431 at Rosemount Inc.	5CB-905
19.	Pricing of Purchase Order 176774, Prime Contract DAAK50-84-C-0008 at Parker Hannifan	5CB-902
20.	Pricing of Purchase Order 646412, Prime Contract F34601-84-C-1135 at Boeing Military Airplane Co.	5CB-901
21.	Pricing of Subcontract 6-962106-C-H9, Prime Contract N00019-82-C-0106 at Hydraulic Research Textron	5CB-904
22.	Pricing of Purchase Order 240002 Prime Contract DAAK50-84-C-0008 at Hydraulic Research Textron	5CB-904
23.	Pricing of Purchase Order J03630, Prime Contract F34601-83-C-0540 at Boeing Military Airplane Co.	5CB-901
24.	Pricing of Purchase Order J03631, Prime Contract F34601-83-C-0540 at Boeing Military Airplane Co.	5CB-901
25.	Pricing of Purchase Order J02839, Prime Contract F34601-83-C-0540 at Boeing Military Airplane Co.	5CB-901
26.	Pricing of Purchase Order 2832, Prime Contract F34601-82-C-2394 at Boeing Military Airplane Co.	5CB-901
27.	Pricing of Purhcase Order 1223, Prime Contract F34601-82-C-2394 at Boeing Military Airplane Co.	5CB-901

	TITLE	PROJECT NO.
28.	Pricing of Contract F42600-79-C-5600 at Sargent Fletcher	5CB-906
29.	Pricing of Contract F42600-82-C-5959 at Sargent Fletcher	5CB-906
30.	Pricing of Contract F42600-82-C-6044 at Sargent Fletcher	5CB-906
31.	Pricing of Contract N00024-83-C-2033, at Warren Pump, Division of Houdaille, Inc.	5CB-921
32.	Pricing of Purchase Order 12503006 at Textron, Valencia, CA	5CB-904
33.	Pricing of Purchase Order NJ00474, Prime Contract N00019-83-C-0272 at Aircraft Porous Media Inc.	5CB-905
34.	Pricing of Purchase Orders BE747154 thru BE747157, BE751309, and BE751310, Prime Contract N00019-83-C-0311 at Aircraft Porous Media, Inc.	5CB-905
35.	Pricing of Purchase Order PW227B74, Prime Contract F33657-84-C-2014 at Aircraft Porous Media, Inc.	5CB-905
36.	Pricing of Purchase Order PW227B75, Prime Contract F33657-83-C-2001 at Aircraft Porous Media, Inc.	5CB-905
37.	Pricing of Purchase Order SP205974, Prime Contract N00024-81-C-4209 at Sperry, Charlottsville	5CB-912
38.	Pricing of Purchase Order 0028, Prime Contract DAAA09-81-C-2008/D0#31) at Mine Safety Applicance Company	4CB-095

PLANNED AUDITS

1.	Multi-Tiered Subcontracting: Contractor Profits and Costs	6CC-XXX
2.	Post Award Negotiations with Subcontractors	6CD-XXX
3.	T-46A Training Aircraft Acquisition	6MA-XXX
4.	Laser Hellfire	6MB-XXX

	TITLE	PROJECT NO.
5.	Acquisition of Remotely Piloted Vehicles	6MB-XXX
6.	Multiple Launch Rocket System/Terminally Guided Warhead (MLRS/TGW)	6MB-XXX
7.	M88A1-Medium Recovery Vehicle	6MB-XXX
8.	Acquisition of Submarine Advanced Combat System	6MC-XXX
9.	Acquisition of the MK-48 Torpedo Program	6MC-XXX
10.	Procurement of Defense Meteorological Satellite Program Satellites	6MD-XXX
11.	Procurement of Payload Assist Module - Delta Class Upper Stage	6MD-XXX
12.	Contractor Make-or-Buy	5CD-XXX

* Additional subcontractors will be included in our future defective pricing audits.

Mr. BROOKS. Thank you, General.

How do you explain the Navy's low recovery rate in defective pricing cases? They've recovered about 12 cents on the dollar.

Mr. VANDER SCHAAF. Yes. We don't have a final answer on that yet. We are in the process of making a review of the problem.

The Navy has reported 63 defective pricing audits closed in our last semiannual report, and they sustained only $3.3 million of the $26.5 million that the auditors had questioned.

Mr. BROOKS. That's $3 million out of 25?

Mr. VANDER SCHAAF. Three out of 26; yes, sir.

Mr. BROOKS. Well, most plaintiff lawyers could do better in my district, I'll tell you.

Mr. VANDER SCHAAF. I wish the Navy could. But to date, we've gone back and looked at 25 of those 63 audits, to make sure there was not a reporting mistake. We found that there wasn't. We did find some very minor adjustments in the reported statistics.

However, what we're finding is poor communications between the contracting officers and the auditors. The contracting officers have not told the auditors what they received in the way of pricing data, in some cases. There was poor communication after the audit report was issued, which led to misinterpretation of the audit findings and overreliance on the contractor's rebuttal to the audit report. In other words, the contracting officer didn't always go back to DCAA and get a full explanation of the basis for their recommendation. We have also gone a little further in this on some specific cases. We believe there is a systemic flaw at one contract audit and contract administration location. We found that at this location. The whole process is flawed. At that location there were 8 contracts of the 25 we've reviewed so far. The amount of money in those 25 was approximately $10 million, and we had zero recovery with that particular contractor.

The situation there was not particularly good, and we are examining that further.

Mr. BROOKS. What are the reasons given when the Government's rights for future claims are waived in settling a defective pricing claim on a given issue?

Mr. VANDER SCHAAF. The trial attorney in this case, who, incidentally, is a very good trial attorney, felt that this was the best deal he could get with this contractor based upon the legal merits of the case. I have gotten to know him after this incident and he and I have worked hard on trying to find a way to encourage the Congress to improve the Truth in Negotiations Act.

However, we felt that he did not know how much other defective pricing information might be present in other contracts. He hadn't checked it out, and he should not have gone so far as to make an agreement that if we find defective pricing in other contracts, we are going to waive our right for recovery on those.

Mr. BROOKS. He settled on one and waived five.

Mr. VANDER SCHAAF. I believe he settled on five.

Mr. BROOKS. And who knows what was in the five?

Mr. VANDER SCHAAF. Well, we have a pretty good idea what were in the five. However, there were others, sir. There were portions of these contracts also that had not been audited to the extent they could have been or should have been. The Government gave something up there, I believe.

Mr. BROOKS. Would you give us some information about the eight Navy defective pricing audit reports awaiting legal review for over a year?

Mr. VANDER SCHAAF. Yes, sir. Here, we had a situation at the Navy Aviation Supply Office in Philadelphia. They had an unwritten policy, but probably also a good policy, that all defective pricing audit reports would be submitted to the Office of Counsel.

Unfortunately, the Office of Counsel did nothing about them for long periods of time. We found the eight of them had not been reviewed for over a year. They hadn't been looked at. We also have found historically that when audit reports are not acted on for long periods of time, the Government's recovery on those audit reports nosedives.

We felt that this is not a good practice at that particular office. We have told the Navy Director of Contracts and Business Management that he ought to look into the matter. He's agreed to look into it, to see what he can do about getting rid of the backlog. He told us he would give us a response in November.

Mr. BROOKS. When did you give him the letter?

Mr. VANDER SCHAAF. I think we gave him the letter—when did we send him the notification, Mr. Lieberman?

Mr. LIEBERMAN. We sent a memorandum in the first week in September and gave him 60 days to respond, Mr. Chairman.

Mr. VANDER SCHAAF. I'm not so sure that 60 days is the appropriate amount of time. We should have sped that process up a bit.

Mr. BROOKS. You think about 10 days would be better?

Mr. VANDER SCHAAF. About 2 weeks might have been adequate. Sometimes in the bureaucracy, we don't get answers. I find that when you give them 60 days, delays occur.

Mr. BROOKS. Then they want an extension; they want 90.

Mr. VANDER SCHAAF. Right. They don't do anything with it until the 50th day anyway.

Mr. BROOKS. And then they want to wait until next year.

Mr. VANDER SCHAAF. This particular case or situation illustrates the kind of problems our contracting officers face and how dependent they are upon others. They take a lot of the blame for this situation, and they don't always deserve it, Mr. Chairman. They're dependent upon lawyers, price analysts, auditors, special kinds of analysis, technical analysis, et cetera. They quite often unfairly get the blame in this process. I want to point that out as well, because, you know, that a poor contracting officer couldn't do anything to settle those claims until they have a legal review.

Mr. BROOKS. He doesn't have to sign it, though.

Mr. VANDER SCHAAF. Absolutely. And he didn't sign them either.

Mr. BROOKS. Would you provide some examples of fraudulent acts relating to certified pricing data, which have been referred to appropriate investigating organizations?

Mr. VANDER SCHAAF. Yes, sir. Up until recently, we hadn't really referred a lot of the defective pricing type audits for followup by investigations. We find a contractor maintaining two sets of records, or the contractor continually losing or denying the auditors access to records that are pertinent to the defective pricing review. We see contractors award subcontracts shortly after the date of certification. They award them at lower prices and to different subcontractors from the subcontractors they proposed to award them to when they were negotiating with the Government.

Mr. BROOKS. Shopping for the subcontractors.

Mr. VANDER SCHAAF. Yes. Mr. Conahan had some examples in his statement.

Mr. BROOKS. They shop for subcontractors to do the work at less cost and then the prime contractors take the profits.

Mr. VANDER SCHAAF. It is a two-way street, and I'm sure that Mr. Wade will bring this out. We have to be careful about it. We want to give the prime contractors the incentive to get the best price possible.

Mr. BROOKS. Right.

Mr. VANDER SCHAAF. And one way we can do that is say, "OK, let's negotiate. We'll finish negotiations, and then you go work those subcontractors over some more."

The problem with that method of doing it is, the Government quite often doesn't get a good share of the savings realized by the prime contractor.

Mr. BROOKS. Right.

Mr. VANDER SCHAAF. At least not initially. Now if it's a 1-year contract, if we're on the ball, and we get good cost and pricing data, we can pick it up on the second year's contract, and do something with it.

Mr. BROOKS. You are dreaming again. That isn't realistic.

Mr. VANDER SCHAAF. I'm not trying to justify missing it in the first place.

Mr. BROOKS. Once they beat you out of it, you don't get it back.

Mr. VANDER SCHAAF. I'm saying they can beat us out of it 1 year, but if we are on the ball, they aren't going to beat us out of it for the next 5 years. We have to be very careful about the multiyear

situation. If we go into a multiyear contract and don't get cost and pricing data from subs, we are leaving ourselves open for 3 to 5 years' worth of procurement at an excessive price.

Mr. BROOKS. They love that.

Mr. VANDER SCHAAF. We had one case and we brought it to everyone's attention in the Pentagon in 1982. The case involved a multiyear contract. That focused a lot of attention on this problem. I was surprised to see, in some respects, that Mr. Conahan's auditors had found a lot more instances of this in those 10 reviews that they have just completed.

Mr. BROOKS. Now by September 30, 1985—that's last week, this past Monday—there were 51 cases that had been referred for investigation by the DCAA?

Mr. VANDER SCHAAF. Yes; 51 defective pricing cases were referred.

I also ought to explain, there is the perception still held by some around that DCAA isn't making referrals to criminal investigative agencies. That situation has changed completely, Mr. Chairman. In the last—and don't hold me to these exact dates, because locking on the numbers is kind of tough—2 years or so they have made approximately 400 referrals to the Department's investigative agencies, based upon their findings on contract audits. Of these referrals, 51 were for defective pricing. That is just a tremendous turnaround. I want to make you aware of that, because I think that's important.

Mr. BROOKS. All right. But they've got a long way to go. You don't deny that, do you?

Mr. VANDER SCHAAF. I don't. However, the people in my business also have a lot of work to do. Giving us those referrals puts a burden on my investigators. They are going to have to get off their duffs and work as well.

Mr. BROOKS. Now of those six cases of defective pricing referred to the Department of Justice, would you discuss those which are likely to result in prosecution?

Mr. VANDER SCHAAF. Yes; However, I can't discuss the individual cases. These are allegations. I don't want to talk about the specific cases.

Mr. BROOKS. Is Justice moving on all six of them?

Mr. VANDER SCHAAF. I think they're going to move quite fast.

Mr. BROOKS. You think they are going to move quite fast? As of now, do you think they are moving a twitch?

Mr. VANDER SCHAAF. Yes; as of now, I believe two of them are already in grand jury.

Mr. BROOKS. Twitching.

Mr. VANDER SCHAAF. What?

Mr. BROOKS. Two of them are twitching.

Mr. VANDER SCHAAF. Two of them are twitching real well.

Mr. BROOKS. And the other four?

Mr. VANDER SCHAAF. My investigators are trying to put a case together; tie a blue ribbon around it and send it to a prosecutor.

Mr. BROOKS. Could you give us an overall picture of the number of contracts and dollars reviewed for defective pricing and the extent of defective pricing that was found?

Mr. VANDER SCHAAF. In these particular cases?

Mr. BROOKS. No; for your 2 years, 1984 and 1985.

Mr. VANDER SCHAAF. Oh, yes. Not in these cases, but historically or recently.

Mr. BROOKS. Right. Would you put that in the record for us?

Mr. VANDER SCHAAF. All right. I can put it in the record.

[The information follows:]

The following shows the audit coverage by the Defense Contract Audit Agency for its last 2 management years ended June 30, 1984 and 1985.

	Management year—	
	1984	1985
Number of reports [1]	1,155	1,634
Number of defective pricing	400	676
Dollars reviewed (rounded—in billions)	$35	$80
Recommended price adjustment (rounded—in millions)	$345	$640

[1] Generally a report is issued on one (sub)contract or modification.

Mr. BROOKS. What action is taken when contractors refuse access to their records, and how many such cases were there, and are they still contracting with the Government?

Mr. VANDER SCHAAF. They are still contracting with the Government. We are also, of course, involved in some court proceedings on this matter of withholding records from the Government. We've had a favorable outcome on the first of these proceedings.

We looked at a random sample of about 212 defective pricing reports. We found that approximately 11 of the 212 lacked full access to the records. In other words, the reports were qualified because the auditors didn't get full access.

DCAA has issued some new guidance to DCAA auditors on handling access to records problems. As a result our reviews, the DCAA Contract Audit Manual has been changed. Now we are telling the auditor to go ahead and complete that portion of the defective pricing review that he can complete without resolving the access to records problems. The auditors should also elevate the access to records problem right away, and get it to the OIG. If they have trouble and we think there's some reason to believe that they are not getting the necessary cooperation, then we will do something about it.

DCAA has also worked with us, and the Congress has taken note of this situation. There's legislation pending which will give DCAA subpoena authority on its own to get access to those records.

Mr. BROOKS. All right. Well, it needs to be done.

Mr. VANDER SCHAAF. No doubt about it. We agree with you.

Mr. BROOKS. I wouldn't have any trouble. I'd just tell them, "You're not ever going to do business with me again." I would get their attention like that.

But in this world here, they go right back in, have a big fat contract next week.

Mr. VANDER SCHAAF. Unfortunately, Mr. Chairman, it's just not that easy out there in the real world.

Mr. BROOKS. I know.

Mr. VANDER SCHAAF. In many instances we have a weapons system that we've bought half the number we intend to purchase.

We can't very well say, "Well, we're not going to buy the rest of this to outfit the force." We've got many problems where one contractor is the sole-source producer. We just cannot walk away from the contractor.

We have to get the tools that we need to make him put his records aboveboard.

Mr. BROOKS. Contractors always claim that nobody else can build that weapon system. Somebody else can build almost everything, and we ought to start finding somebody else to create competition for those weapon systems.

Mr. VANDER SCHAAF. Well, the Department sometimes is not willing to take a delay.

Mr. BROOKS. Yes, I know. It would be worth taking a delay just to show the contractors that others can do the work. The problem is that everybody is still trying to get sole-source contracts.

Mr. Rowland.

Mr. ROWLAND. Mr. Chairman, there is a rollcall vote, so I think we should probably——

Mr. BROOKS. I have some questions which I will submit for the record.

Thank you.

Mr. VANDER SCHAAF. Thank you, sir.

[Mr. Vander Schaaf's submissions to additional questions of Mr. Brooks and questions of Mr. Horton follow:]

ADDITIONAL QUESTIONS OF MR. BROOKS
FOR MR. VANDER SCHAAF

Chairman Brooks: Provide information on the extent to which the DoD/IG, since its inception, has performed defective pricing work at contractor plants. Provide title of assignments, time expended, the resulting report title and date, and indicate whether the assignment was performed pursuant to a congressional request (do not include oversight reviews of DCAA defective pricing work).

Mr. Vander Schaaf: One of two followup audits to our Defense-wide audit of procurement of spare parts issued in May 1984 is of the 95 contractors identified as having sold unreasonably priced spare parts to Defense. The purpose is to evaluate each contract these contractors have with the Government to determine if defective pricing exists. This audit, directed by the Secretary of Defense, began in October 1984, and is scheduled to last at least through December 1986. The audit is a joint effort with the Defense Contract Audit Agency (DCAA). Our staff primarily performs audits at locations where DCAA does not have a resident staff and DCAA performs the audits at locations where they maintain a resident staff. Close coordination is made to preclude duplication of effort. This audit is the extent of the Defense Inspector General's defective pricing coverage since the inception of that office. There will likely be several hundred reports issued as a result of this audit coverage before we are finished because we are issuing a report for each contract we review as well as for each contractor. To date we have issued 12 final reports as shown in the following schedule.

OFFICE OF THE DEFENSE INSPECTOR GENERAL
DEFECTIVE PRICING AUDIT COVERAGE
AS OF OCTOBER 1985

Audit Title	Date Report Number Amount Defective
1. Audit of Priciing of Contract F34601-81-G-2559, Order 0684, Boeing Military Aircraft Company	February 27, 1985 85-077 $31,386
2. Audit of Pricing of Contract MDA904-83-C-0304, Sperry Univac, Salt Lake City, Utah	May 31, 1985 85-095 $103,869
3. Audit of Pricing of Contract DLA400-83-C-0814, Mine Safety Appliances Company	June 21, 1985 85-096 $63,795
4. Audit of Pricing of Contract DLA400-81-C-5274, Uniroyal, Incorporated, Plastic Products Division	July 3, 1985 85-100 $987,749
5. Audit of Pricing of Contract N00104-82-C-5218, Marotta Scientific Controls, Incorporated	July 12, 1985 85-101 $32,078

6.	Audit of Pricing of Contract DAAA09-81-G-2008, Delivery Order 2, Mine Safety Appliances Company	August 30, 1985 85-111 $1,273,779
7.	Audit of Pricing Buy 1 to Contract F34601-82-C-2981, Boeing Military Airplane Company	September 18, 1985 85-117 $134,031
8.	Audit of Pricing of Contract N00104-82-C-5168, Marotta Scientific Controls, Incorporated	September 24, 1985 85-117 $25,000
9.	Audit of Pricing of Contract F34601-78-C-3144, Sperry Microwave Electronics	September 24, 1985 85-119 $52,097
10.	Audit of Pricing of Contract DAAA09-81-G-2008, Delivery Order 0020, Mine Safety Appliances Company	September 30, 1985 85-123 $22,657
11.	Audit of Pricing of Contract DAAA09-81-G-2008, Delivery Order 0026, Mine Safety Appliances Company	September 30, 1985 85-124 $147,630
12.	Audit of Pricing of Contract DAAA09-81-G-2008, Delivery Order 0007, Mine Safety Appliances Company	September 30, 1985 85-125 $10,684

The 12 final reports identified about $2.8 million in defective pricing that the contracting officer has agreed with. However, this does not mean that the full amount will be collected because additional information may be identified in the staffing process and contractors may find some valid offets not found by the auditors.

Our audit has also resulted in some instances where contractors have had their own internal auditors review contracts after being notified of our visits. As a result of these contractor initiated reviews, contractors have proposed downward price adjustments of over $1 million. For example, General Electric identified $553,000 in defective pricing at its Huntsville, Alabama facility and downward adjustments have been made. We are still reviewing this work to ensure that all defective pricing has been identified.

We have issued over 20 draft reports and are working with contracting officers on these reports to ensure complete understanding of the issues and amounts in question prior to issuing our final audit reports. Also, a number of reports are being held in abeyance pending the outcome of referrals of suspected fraudulent actions at six locations. Full work has been completed on about 80 additional contracts and these reports are in process. About 39 manyears of effort at a total cost of about $1.9 million has been expended on this audit as of September 30, 1985.

Chairman Brooks: Has the DOD/IG ever performed any reviews of contractors' cost estimating systems? If so, give details.

Mr. Vander Schaaf: The IG, DoD, would not review contractors' cost estimating systems unless they pertained to a review of the entire procurement of a particular system. The Defense Contract Audit Agency (DCAA) is responsible within DoD to audit contractors' cost estimating systems. The Assistant Inspector General for Audit Policy and Oversight is performing an oversight review of DCAA's audit coverage on contractors' cost estimating systems. This review is expected to be completed by the end of January 1986.

Chairman Brooks: Has the DoD/IG ever issued any reports on the use of decrement factors in pricing contracts? If so, identify them and provide copies to the subcommitee.

Mr. Vander Schaaf: As part of the audit of procurement procedures for TRIDENT submarines, we found that the quote reduction study used by Electric Boat to support its proposed decrement factor for the TRIDENT III, TRIDENT IV and SSN 688 VII material costs contained defective cost data. Electric Boat had proposed the same decrement factor for the TRIDENT V procurement now in negotiations. We believe the factor is inaccurate and should not be used as a basis for negotiating material costs. We reported this in our "Quick-Reaction Report on the Audit of Procurement Procedures for TRIDENT Submarines," dated March 15, 1985.

As part of our aircraft engine spare parts pricing, we found that the multiyear composite pricing factors that General Electric used to estimate future indirect expenses distorted true costs and profits on spare parts proposals and created the potential for profits beyond the negotiated rates. We reported this in our "Aircraft Engine Spare Parts Pricing, Costing, Negotiation and DoD Review Functions," dated March 21, 1985.

In our "Report on the Audit of the Acquisition of SSN 688 Nuclear Attack Submarines," dated October 12, 1984, we reported that the Naval Sea Systems Command (Sea Command) accepted Newport News Shipbuilding and Drydock Company's projection of $21 million in labor costs, which differed from official Navy index projections, in its calculations of profit on the 688 submarines. Sea Command also allowed the Newport News Company to include $8.5 million in the base cost for out-year escalation. Reimbursements for escalation should be under the economic price adjustment clause. As a result, the Newport News Company's risks have been minimized, and it could receive additional profits of $6.9 million.

In our "Report on the Audit of the SGT York Division Air Defense (DIVAD) Gun System," dated September 10, 1984, we reported that the planned negotiation strategy of the Armament Command for spare parts was not conducive to obtaining fair and reasonable prices in every instance. Negotiators intended to negotiate each delivery order on a bottom line basis and allocate any cost increase or decrease equally to the unit price of each part. For example, if a negotiation resulted in a 10 percent bottom line reduction on the delivery order, then each line item on the order

would be reduced 10 percent. This method of pricing tends to ignore the true value or cost of the part and is based instead on some predetermined factor, such as a percentage reduction.

Also, in our audit of "Pricing Support For Spare Parts Provided by the Defense Contract Administration Services," dated June 11, 1984, we found that spare parts prices on certain procurements for two Basic Ordering Agreements were derived by applying a prenegotiated decrement rate to the contractor's proposed prices without the benefit of pricing analysis. Officials told us this method was used because limited resources prevented detailed reviews of cost or pricing data for low-value (under $25,000) orders.

Copies of these reports are enclosed.

[SUBCOMMITTEE NOTE.—The reports were retained in Subcommittee files.]

Chairman Brooks: Cite the details of some cases in which the Government lost defective pricing refunds because the price negotiation memoranda were poorly prepared and those representing the Government had to speculate as to what was provided by the contractor and what was relied on by the contracting officer.

Mr. Vander Schaaf: We have reviewed several cases where the Government was unable to carry the burden of proof necessary to prove that the contractor certified inaccurate, incomplete, or noncurrent cost or pricing data.

In one 1985 defective pricing case, the price negotiation memorandum was not sufficiently detailed to attribute the materials cost reduction, which occurred prior to certification, to specific parts. Furthermore, the Navy contract negotiator, who had since retired, had no specific recollection of the events surrounding this contract. He was unable to comment on whether the contractor (Sperry Corporation) informed him of the reduced price on the parts in question and whether they were included in a $249,425 reduction negotiated prior to certification. The cognizant Navy legal office determined there was insufficient evidence to show the contractor did not reveal the lower prices on the parts prior to certification.

In two other recent cases, we found the price negotiation memoranda prepared by Air Force contracting officers did not contain sufficient information to challenge the contractor's (Westinghouse Corporation) claim that the data was provided. The Government negotiating teams were unable to recall the specific details. Again, the cognizant DoD legal office advised that the Government would be unable to prove defective pricing of $841,666 alleged by the auditors.

Chairman Brooks: Have there been any offsets of defective pricing findings pertaining to a contract against an understated cost in a different contract? If so, cite details.

Mr. Vander Schaaf: No, we have no knowledge of any cases involving offsets of defective pricing against an understated cost in a different contract. However, we have identified instances of defective pricing cases not closed in accordance with DoD policy. For example, one Air Force case was settled as a downward price adjustment to an open contract subject to progress payments instead of a check for $111,000 to the U.S. Treasury on the closed contract where defective pricing occurred. The Air Force then applied the recouped funds to other Air Force programs.

Chairman Brooks: Cite some examples where disposition of defective pricing findings were adverse to the interests of the Government.

Mr. Vander Schaaf: In our audit report of "Contracting Officer Decisions on Contract Audit Recommendations," published on August 16, 1985, we reported 4 cases out of 16 defective pricing cases reviewed in which the contracting officers did not settle contract audit recommendations for the complete amount of the defective pricing findings, even though the audit findings were accurate. We concluded that, if improved guidance had been available and if contracting officers had unilaterally issued decisions when the Government's case was strong, the Government might have saved an additional $1.7 million on these four audits. The Navy and the Air Force nonconcurred with these conclusions.

In another group of five reports reviewed by my Audit Followup staff, contract auditors identified $15.6 million of defective pricing by an Air Force contractor, who appealed the contracting officer's decisions to the Armed Services Board of Contract Appeals. These cases were settled out-of-court by an Air Force senior trial attorney. The agreed-upon settlement was for $2 million. Because the defective pricing pertained to fixed-price-incentive contracts, the real harm to the Government was $4.7 million, and we believe the $2 million settlement figure was too low. Moreover, the Government negotiator improperly waived the Government's right to make future defective pricing claims on the contracts involved. The Air Force disagreed that the settlement was necessarily adverse to the interests of the Government, but did agree to prohibit agreements waiving the Government's right to future defective pricing claims.

A final example concerns six defective pricing cases in which Navy contracting officers sustained none of the $8.1 million in audit findings. In each case, the Navy had allowed the contractor to submit and certify to outdated cost and pricing information. A decrement factor was then used in lieu of current cost and pricing data. Although it is difficult to determine if any actual monetary loss to the Government occurred because of this practice, we believe that it is contrary to the intent of the Truth in Negotiations Act and improperly places the Government's interest at risk. This matter has been reported to the Navy, and we are awaiting their response.

Chairman Brooks: Do you have any evidence where a Defense Contract Audit Agency auditor had been aware of deficiencies in a contractor's cost estimating system but did not report them to the contractor or to the contracting officer?

Mr. Vander Schaaf: No. As I mentioned in my response to question number 2, we have an oversight review in process. We have not found any evidence to date that Defense Contract Audit Agency auditors are aware of deficiencies in a contractor's cost estimating system but did not report them to the contractor or to the contracting officer. Our concern is that perhaps not enough time is spent auditing the estimating system. In orther words, audit is used to verify the results of the cost accounting, purchasing and estimating systems rather than addressing the adequacy of the systems.

QUESTIONS OF MR. HORTON
FOR MR. VANDER SCHAAF

QUESTION: The GAO found that "most prime contractors substantially complied with the provisions of the Truth-in-Negotiations Act." By contrast, you place great emphasis on increased defective pricing activity. Is there a difference in view between you and GAO?

ANSWER: We do not think there is a difference in view between the IG and GAO. The GAO in their statement indicated that prime contractors substantially complied with the provisions of Public Law 87-653. However, they indicated ten prime contracts were overpriced by about $7.4 million because updated subcontractor information was not disclosed to the Government. Thus, all contractors are not complying with the requirements of the law. The DCAA is finding more than one case of defective pricing in every three reviews. In their management year ended June 30, 1985, DCAA found 676 cases of defective pricing in 1,634 reviews. The amount of recommended price adjustment was about $640 million. We believe there are defectively priced contracts that must be audited by DCAA and as shown, these dollars are not immaterial. Both the GAO and the IG agree tnere should be greater emphasis on correcting estimating system deficiencies which should reduce the amount of defective pricing. However, the need to perform defective pricing reviews will still exist.

QUESTION: The IG stated in an earlier report, dated January 16, 1984, that; "DCAA generally provided timely and quality audit assistance to DoD contracting officers for subcontractors' pricing proposals." Has anything led you to change this assessment since then?

ANSWER: No. However, we expect to perform another review in the future to ensure DCAA is continuing to provide timely and quality audit assistance on subcontractors.

QUESTION: The DCAA auditors have come under well-publicized criticism over the past couple of years for accepting too readily their advisory role to contracting officers and for not asserting greater independence from them. Yet, you have stated that poor coordination and poor communications between DCAA auditors and the contracting officers have created problems in the settlement of defective pricing audits, indicating excessive independence. Which criticism is more valid?

ANSWER: There can be independence and communication. We do not believe they must be separate. We have recommended to DCAA that they discuss defective pricing with the contracting officers to ensure that the defective cost or pricing data was not disclosed when a contractor states it was disclosed. This discussion should not reflect on the auditor's independent opinion. We believe the auditor must be independent; however, this does not preclude him from coordinating and discussing defective pricing audits with contracting officers.

QUESTION: Please explain the difference in practice that should result from implementation of changes you have proposed to DoD Directive 7640.2 on audit follow-up. What has DCAA's responsibility been up to the present for elevating unresolved audit recommendations?

ANSWER: I should first make it clear that the DoD components have not yet had an opportunity to comment formally on our proposals for changes to DoD Directive 7640.2. After they do so over the next several weeks, we may make additional changes or alter those which we wrote into our initial draft revision.

In general, we feel that the Directive should be updated to incorporate the lessons learned in the contract audit followup program in the three years since that document was last revised. This includes revising and clarifying definitions and reporting requirements, as well as putting more emphasis on certain areas. For example:

- The performance appraisal plans for contracting personnel should include audit resolution as a critical element.
- Decisions by contracting officers to negotiate with contractors despite DCAA recommendations not to do so should be reviewed by independent senior acquisition officials.
- Explicit price negotiation memoranda should be provided on a timely basis to the DCAA.

- The DCAA should notify the DoD component contract audit followup officials when there are serious violations of DoD Directive 7640.2 or when they feel that the Government's interests have not been well served in the handling of their reports. If the issue cannot be settled, the DCAA should advise the Office of the Inspector General.

Regarding the elevation of unresolved recommendations, it should be understood that it is the contracting officer's duty, not the auditor's, to elevate disputed items to the designated review official. The contracting officer is prohibited from resolving a disputed audit report until this review has occurred. We are not proposing a change to this procedure in the revised Directive.

QUESTION: I realize that there has been some disagreement between you and DCAA on defective pricing audit "sustention rates," i.e., over how to record audit resolutions when a recommendation is sustained by a contracting officer but hasn't yet resulted in the actual recovery of funds. Whether based on sustention rates as you calculate them or on the higher sustention rates as DCAA has calculated them in the past, the dollar payback from defective pricing reviews appears lower than from other types of audit activities. (Part 1) Should this payback be a consideration in the amount of effort put into defective pricing audits? (Part 2) Is the main purpose of your emphasis on defective pricing to get contractors to improve their estimating systems? (Part 3) If so, could this purpose be achieved more easily and economically than by redirecting DCAA's activities?

ANSWER-PART 1: The payback from defective pricing is real dollars either returned to the treasury or not paid on existing contracts. Whereas, the high payback rates occur on preaward audits where the proposals may contain some "costs" for negotiation purposes. We believe payback should be a consideration but not the only consideration. The Public Law was designed to substitute for a lack of competition and prevent contractors from reaping unearned and excessive profits. Defective pricing reviews are the means for recouping the dollars contractors obtained because they did not disclose current, complete and accurate information to the Government.

ANSWER-PART 2: Yes. Getting contractors to improve the estimating system is important. Even with increased emphasis on improving estimating system defective pricing will still occur. Our main purpose is to ensure that the Government pays a fair and reasonable price and is not overcharged because data presented at negotiations was not accurate, timely or complete.

ANSWER-PART 3: We do not think we are redirecting DCAA's effort but reemphasizing the need for increased concentration on defective pricing and estimating system reviews. We feel these are two important areas that DCAA should have always concentrated on.

QUESTION: One of the possible outcomes from renewed attention to contractor estimating systems may be a recommendation for use of standardized estimating methods and practices. (Part 1) Do you believe that would be advisable? (Part 2) What elements should a standardized estimating system provide for? (Part 3) How would such a standard overcome the lack of timeliness which was such a major deficiency in the review conducted by GAO?

ANSWER-PART 1: We do not believe a set of standardized estimating practices could be developed which would apply to all contractors. We do believe contractors should be required to have written estimating procedures. Also, these procedures and subsequent changes should be reviewed and approved by the Defense Contract Audit Agency and the Administrative Contracting Officer as a condition of contracting with the Department of Defense.

ANSWER-PART 2: The written estimating system procedures should identify all elements of costs included in contractors bid proposals. The procedures should stipulate the techniques used and documentation required to develope and support each element of proposed costs. Furthermore, the procedure must provide for consistency between estimating and accounting of costs in accordance with Cost Accounting Standard 401.

ANSWER-PART 3: The untimeliness GAO referred to was the resolution of estimating weaknesses by contracting officers. If the system has to be approved as a condition of contracting, the contractor has no alternative except to correct the weaknesses or have his system disapproved and not be allowed to do business with the Government.

QUESTION: The high priority you and GAO place on closer surveillance of cost estimating systems by DCAA seems based on the expectation that such an effort would alleviate much of the subsequent burden in conducting pre-award surveys. (Part 1) How long should it take that positive effect to show, and how long should it be before the demand on DCAA for pre-award audits would decline? (Part 2) Are additional resources needed before DCAA can support this effort, or do you believe DCAA could act now, even before the feedback effects are felt, to shift resources away from pre-award work?

ANSWER-PART 1: We think the effect should be immediate on the accuracy of the contractor's proposal. However, the demand on DCAA for pre-award audits in terms of numbers of audits may not decline. The probability is that DCAA will have greater reliance on the contractor's estimating system and not have to expend as many audit hours evaluating a pre-award proposal. This would help to make additional hours available for audits of subcontractor proposals which is an area where we have identified significant weakness in audit coverage.

ANSWER-PART 2: We are not sure DCAA will need additional resources to support this effort. There may be a need to shift some resources to the evaluating of contractor's estimating systems, however, the improved systems should reduce the audit hours required on each proposal.

QUESTION: A number of points have been made about the practice of applying a "decrement" to a pricing proposal to approximate the amount by which a subcontract proposal is likely to be negotiated downward by the prime contractor. Prime contractors generally "decrement" subcontract pricing proposals in their own proposals to the Government, and such a decrement is an element which some auditors believe is required in a satisfactory subcontract cost estimating system. Yet, we have heard this morning that decrements are an inadequate measure when they are used by contracting officers. What is your view on the proper use of decrements?

ANSWER: Prime contractors historical experience in negotiating lower prices with its subcontractors after receiving a contract from the government should be proposed as a decrement to subcontract costs. These lower price negotiations normally occur with subcontractors when there is no requirement for them to submit cost or pricing data subject to audit. The prime contractors estimating system should provide for consideration of this experience in all bids submitted to the government. However, decrements cannot be used by contracting officers in lieu of audit review of subcontractor books and records when subcontractor bids are based on cost or pricing data.

QUESTION: You find the distinction often made between "internal" and "contract" audit functions to be artificial. Please give us examples of how better coordination or communication between DCAA contract auditors and internal auditors from the Services, for example, have helped achieve mutual objectives.

ANSWER: The differing roles of internal and contract auditors are clearly delineated in DoD policy guidance. In the procurement area, internal auditors are responsible for evaluating the performance of DoD procurement officials and the contract auditors are responsible for providing financial advice to the contracting officer for negotiation and administration of contracts. This is a somewhat artificial separation because procurements are not audited in their entirely to include the actions of both government and contractor personnel

An example of a coordinated audit involving internal and contract auditors was the recent audit of the pricing of spare parts. The four DoD internal audit organizations performed work at procurement activities to identify potential candidates of overpriced spare parts. The contract auditors reviewed contractors' records to evaluate the reasonableness of the prices of spare parts identified by the internal auditors. The information provided by the contract auditors was used by the internal auditors to prepare audit reports on the results of the audit.

Mr. BROOKS. Our final witness will be Dr. Wade. We will go and vote and return very quickly. Thank you.

We will recess for about 10 minutes.

[Recess taken.]

Mr. BROOKS. We will reconvene.

Our last witness is Dr. James P. Wade, Jr., Assistant Secretary of Defense for Acquisition and Logistics. Before assuming his current position, he was the Principal Deputy under the Secretary of Defense for Research and Engineering. He is accompanied by Jack Kendig, Director of Cost, Pricing, and Finance.

We appreciate your being here, Dr. Wade, with your associate, and we would accept your statement for the record, and appreciate any comments you might want to make at this time.

STATEMENT OF DR. JAMES P. WADE, JR., ASSISTANT SECRETARY OF DEFENSE FOR ACQUISITION AND LOGISTICS, U.S. DEPARTMENT OF DEFENSE, ACCOMPANIED BY JACK KENDIG, DIRECTOR OF COST, PRICING, AND FINANCE

Dr. WADE. Thank you, Mr. Chairman and members of your subcommittee.

I am pleased, as always, to have the opportunity to appear before you, and now, at this time, to present my views and the DOD initiatives on pricing major subcontractors' proposals, unallowable costs, and defective pricing.

As you indicated, I do have a rather lengthy, detailed statement for the record. I would like, at this time, to summarize what I have in the statement.

Mr. BROOKS. Is it shorter when you summarize or longer?

Dr. WADE. Well, I can do it as short as you want, sir. We can go right to questions, if you'd like. Most of this has been covered this morning.

Mr. BROOKS. Go ahead and take a few minutes and lay it out, a few highlights, and then we'll get to some questions.

Dr. WADE. All right, sir.

There is indeed a dilemma with regard to the timing of the negotiations of subcontractors' price proposals. Two options, indeed, exist, that we can either negotiate with the prime contractor before he negotiates with the subcontractors, or we can negotiate with the prime contractor after he negotiates firm subcontract prices.

Our policy is to negotiate with the prime contractor before he negotiates firm subcontract prices, and for the following reasons:

First, we eliminate the possibility of contracting officers merely accepting the prices that prime contractors negotiate with subcontractors. Once the prime negotiates a firm subcontract price, it is indeed very difficult for the Government to negotiate a lower price with the prime.

Second, the prime has a monetary incentive to negotiate lower subcontract prices, because they will indeed share in any resultant savings that come about if they negotiate lower subcontract prices than were negotiated with the Government.

And third, the Government also benefits if the prime contractors are able to negotiate lower subcontract prices. On incentive type contracts, the Government will share in the savings on the instant

contract. We, indeed, realize the full savings on follow-on buys for both firm fixed price and incentive contracts.

And fourth and last, our procedure also allows us to definitize the prime contract price at an earlier date.

Now here, we recognized in late 1983 that we had some rather significant problems in the pricing of major subcontracts. As a result, the Deputy Secretary of Defense then issued a memorandum to the service Secretaries emphasizing our policies in the area of acquisition planning, cost estimating systems, adequacy of contractor submissions of cost and pricing data, developing prenegotiation price objectives, and negotiation of the contract price.

More recently, we initiated a review of our procedures for pricing major subcontracts, and we are, indeed, primarily concerned with two areas.

First, should we continue our current practice, negotiating with the prime contractors before they negotiate the firm subcontract prices? And second, should the Government increase its participation in the review of subcontractor price proposals through increased audits by DCAA?

In this respect, we look forward to receiving the GAO report on their review of subcontracts, because it will provide more current information to help us further assess the current situation.

Now increasing competition is a major initiative in the Department of Defense. However, even where it is necessary to award a contract by other than competitive means, our regulations require that the prime contractor shall select subcontractors on a competitive basis to the maximum practical extent. Accordingly, the Federal acquisition regulation clause at 52.244-5, "Competition in Subcontracting," is included in such prime contracts valued at $500,000 or more.

We also maintain surveillance over the contractor's purchasing system with formal scheduled reviews.

The Department shares the subcommittee's concern over some of the defense contractors' practices of claiming reimbursement for questionable, and in some cases expressly unallowable, overhead costs. We have taken, indeed, a number of positive steps to correct this problem.

Let me address, in part, Public Law 87-653, commonly called the Truth in Negotiations Act.

While providing the Government the right to a contract price adjustment under certain conditions, it is primarily intended to avoid overpricing by assuring that the Government has equal knowledge of facts affecting contract pricing. I would like to outline here some of the actions taken by the Congress and the initiatives by DOD to strengthen the law and its implementation.

First, as you know, Congress lowered the threshold from $500,000 to $100,000, requiring certified costs and pricing data. DOD responded by lowering the threshold for obtaining field pricing reports from $500,000 to $100,000 for firm fixed-price contracts.

We next changed our regulations so that contracting officers may no longer waive the requirement for field pricing, unless it is approved in writing at a level above the contracting officer. We have issued guidance to require the contracting officers to keep auditors informed of planned prenegotiation and negotiation activity, and

invite contract audit participation when a significant contribution can be made.

The DAR Council is considering a proposed change to the regulations to provide for recovery of interest on defective pricing overpayments. And also the DAR Council is considering a provision to further strengthen our regulations in cases where contractors deny access to supporting documentation and records.

On April 19 of this year, I issued directives to the services, the DLA, and DCAA that prohibit contracting officers entering into agreements to restrict the access by DCAA auditors to selected contractor records. And we have recently initiated a change to the regulations to require that field pricing reports shall include DCAA audit reports.

A recent DOD/IG report, covering both contracting officer decisions and contract audit recommendations, stated that contracting officers sustained 75 percent of costs questioned by DCAA auditors. The audit report covered a cross section of various types of audit reports and included defective pricing, preaward audits, incurred costs, et cetera. The report also reflected that significant recoveries in defective pricing audits had been advanced and achieved in 75 percent of the cases.

Mr. BROOKS. Would the gentleman yield?

Dr. WADE. Yes, sir.

Mr. BROOKS. Maybe I don't understand that. In the audit report of August 16, 1985, we noted on pages 6 and 7 that the sustention rate was 21 percent. And over here on the overall total, you show 33 percent.

Is that a different language?

Dr. WADE. Yes, sir, Mr. Chairman. I think a problem exists here, and we need to clarify it, and that is, there is a difference between what is recommended by the contracting officer, and those also will include the appeals that will go to the ASBCA. And the IG numbers, in effect, set aside the appeals. I think, in that case, the way to fix that is to be clear in the sense of how we present the data.

Mr. BROOKS. You say support reform on the next page and the Truth in Negotiations Act. I have not looked at the list, but certainly we ought to support some that we can get worked out. We appreciate your recommendations on that.

Are you working to improve the contractors' estimating systems, realizing that is where we waste a lot of money? We are in deep trouble because of the inadequacies in the estimating systems.

Do you disagree with that?

Mr. KENDIG. I do not disagree.

Dr. WADE. I think the key point here is, if you have a sound proposal by the prime, that, by definition, should entail also the sound input to the prime proposal as far as the subs are concerned. If they are not sound, then the contracting officer should hold off and make sure he has a sound proposal before he proceeds.

Mr. BROOKS. They get this curious motivation, and they call it pressure from above, to complete the contract. But I don't see any pressure for them to do nothing, if they are just throwing away billions of dollars. That does not buy good defense.

Dr. WADE. Yes, sir.

Mr. BROOKS. In my judgment.

Dr. WADE. There certainly is a needed time in reference to getting this equipment out in the field, but if you allow the system to be such that, by holding off and making sure it's correct, they'll respond, once they get that signal that that's the way the process is going to work.

Mr. BROOKS. Of course, I like the question that one of the members asked about why is it they don't have time to get a good evaluation of how much the subcontracts would cost before they sign the prime contract.

Mr. Secretary, what has the DOD done to improve the quality of price negotiation memorandums?

Dr. WADE. Well, Mr. Chairman, over the past 4-plus years, we have introduced additional guidance, for example within the FAR.

The Armed Services Contract Pricing Manual contains extensive additional guidance on this subject, and as I indicated before, the Deputy Secretary, on November 3, 1983, emphasized the importance of the price negotiation memorandum and the requirement that it address all significant issues discussed during the course of the negotiations.

On June 18 of this year, I also issued additional memorandums to the services, requiring documentation in price negotiation memorandums by cost element. This new documentation should be most helpful in identifying defective pricing and the subsequent recovery of funds.

Mr. BROOKS. We will put this in the record, particularly the November 3, 1983, memorandum which said, "The prime contractor is responsible for performing an analysis of prospective subcontractor proposals. However, this must be reviewed for adequacy."

[The information follows:]

THE DEPUTY SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

3 NOV 1983

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL
INSPECTOR GENERAL
ASSISTANTS TO THE SECRETARY OF DEFENSE
DIRECTORS OF THE DEFENSE AGENCIES

SUBJECT: Negotiated Single Source Procurements

The goal of DoD is to place as many contracts as possible on a competitive basis; however, a large dollar amount of contracts are awarded on other than a competitive basis each year. When contract prices are not established on the basis of price competition, extreme care is required to ensure that fair and reasonable prices are negotiated. Recent reports issued by the GAO, Inspector General, and Congressional Committees indicate a need to reemphasize some of our basic policies and procedures regarding negotiated single source procurements.

Acquisition Planning

Acquisition planning involves analysis of the technical and operational requirements and the documentation of the appropriate business strategy, and other acquisition policy considerations. To be effective, the plan must contain realistic milestones to be met in achieving the goals of a program. Accordingly, it is mandatory that adequate time be provided to allow for a proper evaluation of the contractor's proposal and for contract negotiations.

Preproposal Effort

A key element in the timely negotiation of a fair and reasonable price is to start with a well-prepared and well-documented contractor proposal. In this regard, we must ensure that contractor estimating systems are formalized and follow good estimating procedures; that contractor accounting systems properly accumulate costs for historical purposes; and that contractor purchasing systems are adequate. In addition, other contractor policies and procedures that affect the quality of cost proposals should be reviewed.

Evaluation of Contractor Proposal

One of the more significant steps in the evaluation of the proposal is to determine if it provides an adequate basis for negotiations. Of particular concern in this respect is whether or not adequate cost or pricing data, including prospective subcontractor cost or pricing data, has been provided. Deficiencies noted in this process should be immediately corrected. Field pricing reports should be obtained in accordance with the DAR. This includes a technical review as well as a financial review. While all of the cost elements in a proposal are important, purchased parts and subcontracts have been recently highlighted as having needed a more indepth review. Value analysis as well as cost and price analysis should be used on purchased parts. The prime contractor is responsible for performing an analysis of prospective subcontractor proposals. However, this must be reviewed for adequacy. The contractor's make-or-buy program should be reviewed and incorporated into the contract under the circumstances described in the DAR.

Negotiation of Contract Price

A prenegotiation price objective should be established for all negotiated procurements prior to the start of contract negotiations. Management approval of the objective should be obtained following departmental procedures. A record of price negotiations should be prepared at the conclusion of negotiations and, when required, a copy furnished to the ACO and auditor. It is important that this document address all significant issues discussed during negotiations.

I want to emphasize that this memorandum is not intended to represent a step-by-step guide in the contract negotiations process. It simply calls to your attention some of the more serious problems that have surfaced in the past few months. It is our joint responsibility to see that all personnel in the procurement branches of the Department are aware of these problems so they may be avoided in future contracts. I am also aware of your already increased workload in the procurement area. However, we must devote sufficient attention and resources to these procurements to ensure that fair and reasonable prices are negotiated. Your cooperation is appreciated.

Paul Thayer

Mr. BROOKS. Mr. Secretary, what do you plan to do about the deficiencies that the IG and GAO found in contractors' pricing and estimating systems?

Dr. WADE. Where there are deficiencies, we will, indeed, correct them. And if they entail changes in regulations, then we will change the regulations. And if it means, which, I think, in most cases, just doing a better job of enforcing our regulations, then we're going to take that direction. The bottom line here is, we intend to correct every deficiency that's been identified by our audit agencies.

Mr. BROOKS. Do you have a timetable, perhaps, for a strengthened set of guidelines for them?

Dr. WADE. No specific timeframe, Mr. Chairman.

Mr. BROOKS. Do you understand why I say that? I'm a little nervous about the DOD. They have a slight tendency to say, "We have a committee that's studying this," but they don't ever tell you when they're going to quit studying.

Dr. WADE. Well, our process, indeed, has been too slow over the past few years, and one of my priorities is, even through the process of our DAR procedures, we've just got to be able to move faster on getting these changes into effect and move faster in the sense of the enforcement of current regulations.

Mr. BROOKS. Well, now, what action do you think DOD and the Congress can take to put more teeth back into the Truth in Negotiations Act?

Dr. WADE. Well, first of all, I think we——

Mr. BROOKS. We've lowered it, I know, from $500,000 to $100,000.

Dr. WADE. Well, first of all, sir, we ought to take note that I think some significant improvements have been provided to the system over the last couple of years by the Congress, that we have actually had a major step forward by both the Department and Congress working together.

As I cited before, these changes are in effect, and in my opinion, the best thing that needs to be done is to move out and make sure that they work well and add to the few that, for example, Mr. Vander Schaaf discussed with you this morning.

Mr. BROOKS. But you and the Secretary of Defense do support some changes in the Truth in Negotiations Act?

Dr. WADE. I think we can improve in detail on it; yes, sir.

Mr. BROOKS. Now why do contracting officers use decrement factors to lower subcontractor costs in price proposals?

Dr. WADE. Well, I can't answer specifically the reason why. I would say that if that's what they're depending on, then it's wrong, and we ought to stop it.

The right approach is to get sound input in the sense of what the primes can give you in reference to the subs, and move from there. Demand good input.

It doesn't say that decrement factors are not useful, but they certainly should not be, and they will not be, the prime way in which we do our business.

Mr. BROOKS. You agree, then, I take it, that you should get the pricing data, get that information, and not just rely on the decrement factor?

Dr. WADE. Absolutely.

Mr. BROOKS. Do you think the Government should negotiate a prime contract if the contracting officer does not have a complete evaluation of both the prime's and the subcontractors' price proposals?

Dr. WADE. Well, we certainly should not until we have a sound proposal in front of us, just wait until we get it.

Mr. BROOKS. All right.

Dr. WADE. It doesn't say that you have to have 100 percent of the facts, because then you'd be waiting forever. But I think the contracting officer should be firm in his own position, that he should go into negotiations with a sound proposal in front of him and with the necessary information so that he can do the job right.

[Dr. Wade's prepared statement and submissions to additional questions of Mr. Brooks follow:]

STATEMENT

OF

DR. JAMES P. WADE

ASSISTANT SECRETARY OF DEFENSE

FOR ACQUISITION AND LOGISTICS

GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. I AM PLEASED TO HAVE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO PRESENT MY VIEWS AND DOD INITIATIVES IN THE AREAS OF PRICING MAJOR SUBCONTRACTS, UNALLOWABLE OVERHEAD COSTS, AND DEFECTIVE PRICING.

TIMING OF SUBCONTRACT NEGOTIATIONS

TWO OPTIONS EXIST REGARDING THE TIMING OF NEGOTIATIONS OF SUBCONTRACT PRICES WITH PRIME CONTRACTORS. WE CAN EITHER NEGOTIATE WITH THE PRIME CONTRACTOR BEFORE HE NEGOTIATES FIRM SUBCONTRACT PRICES, OR WE CAN NEGOTIATE WITH THE PRIME CONTRACTOR AFTER HE NEGOTIATES FIRM SUBCONTRACT PRICES. OUR POLICY IS TO NEGOTIATE WITH THE PRIME BEFORE HE NEGOTIATES FIRM SUBCONTRACT PRICES. WE BELIEVE THIS IS PROPER FOR THE FOLLOWING REASONS:

(1) WE ELIMINATE THE POSSIBILITY OF CONTRACTING OFFICERS MERELY ACCEPTING THE PRICES THE PRIME CONTRACTOR NEGOTIATES WITH THE SUBCONTRACTORS. ONCE THE PRIME NEGOTIATES A FIRM-PRICE WITH A SUBCONTRACTOR, IT IS VERY DIFFICULT FOR THE GOVERNMENT TO NEGOTIATE A LOWER PRICE WITH THE PRIME CONTRACTOR WHEREAS BEFORE HE NEGOTIATES, WE CAN INFLUENCE HIS NEGOTIATIONS.

(2) THE PRIME CONTRACTORS HAVE A MONETARY INCENTIVE TO NEGOTIATE LOWER SUBCONTRACT PRICES BECAUSE THEY WILL SHARE IN ANY RESULTANT SAVINGS THAT COME ABOUT IF THEY NEGOTIATE LOWER SUBCONTRACT PRICES THAN WERE NEGOTIATED WITH THE GOVERNMENT.

(3) THE GOVERNMENT ALSO BENEFITS IF THE PRIME CONTRACTORS ARE ABLE TO NEGOTIATE LOWER PRICES WITH THE SUBCONTRACTORS. IF THE PRIME CONTRACT IS AN INCENTIVE TYPE CONTRACT, THE GOVERNMENT WILL SHARE IN THE SAVINGS ON THE INSTANT CONTRACT. IF THE PRIME CONTRACT IS FIRM FIXED-PRICE, THE GOVERNMENT WILL REALIZE THE FULL SAVINGS ON ANY FOLLOW-ON CONTRACTS. THE FOLLOW-ON SAVINGS ALSO APPLY TO INCENTIVE CONTRACTS.

(4) OUR PROCEDURE ALLOWS US TO NEGOTIATE FIRM PRICES OR TARGET PRICES IN THE CASE OF INCENTIVE CONTRACTS AT A MUCH EARLIER DATE THAN WOULD BE POSSIBLE IF WE DID NOT NEGOTIATE THE PRIME CONTRACT PRICE UNTIL THE PRIME CONTRACTOR NEGOTIATED FIRM SUBCONTRACT PRICES.

OUR REGULATIONS DO, HOWEVER, PROVIDE FOR EXCEPTIONS TO THIS GENERAL POLICY SUCH AS WHEN THE CONTRACTING OFFICE DOES NOT BELIEVE ADEQUATE INFORMATION IS AVAILABLE TO NEGOTIATE THE SUBCONTRACT PRICE. IN SUCH A CASE, THE SUBCONTRACT MAY BE SET ASIDE FOR SUBSEQUENT NEGOTIATION.

PRICING OF SUBCONTRACTS

THE PRIME CONTRACTOR AND HIGHER TIER SUBCONTRACTORS ARE RESPONSIBLE FOR EVALUATING SUBCONTRACT PRICES AND INCLUDING THE

BEST COPY AVAILABLE

RESULTS OF THOSE EVALUATIONS AS PARTS OF THEIR OWN COST OR PRICING DATA SUBMISSION. THE CONTRACTING OFFICER MAY REQUEST AUDIT OR FIELD PRICING [illegible]ORT TO ANALYZE AND EVALUATE THE PROPOSAL OF A SUBCONTRACTOR AT ANY TIER (NOTWITHSTANDING AVAILABILITY OF DATA OR ANALYSES PERFORMED BY THE PRIME CONTRACTOR) IF THE CONTRACTING OFFICER BELIEVES THAY SUCH SUPPORT IS NECESSARY TO INSURE REASONABLENESS OF THE TOTAL PROPOSED PRICE. THIS IS NOW BEING DONE FOR SELECTED MAJOR SUBCONTRACTS. THE PRIMARY REASONS FOR RELYING ON THE PRIME CONTRACTORS' ANALYSES ARE THE ADDED COSTS AND ADDITIONAL RESOURCES THAT WOULD BE NEEDED FOR THE GOVERNMENT TO ADEQUATELY EVALUATE, IN DETAILED, ALL OF THE SUBCONTRACTOR PROPOSALS. WHILE WE HAVE NOT CONDUCTED A DETAIL STUDY OF THE ACTUAL RESOURCES NEEDED IF THE GOVERNMENT WERE TO ASSUME COMPLETE RESPONSIBILITY FOR EVALUATING SUBCONTRACTOR PROPOSALS, THE COSTS WOULD BE SUBSTANTIAL. FOR EXAMPLE, SOME LARGE PRIME CONTRACTS CONTAIN 25 TO 100 MAJOR FIRST-TIER SUBCONTRACTS. THE DEPARTMENT HAS ABOUT 95 SAR PROGRAMS, EACH CONTAINING ABOUT 3 OR 4 MAJOR PRIME CONTRACTS. WITH THE SAR PROGRAMS ALONE, THERE ARE ABOUT 300 MAJOR PRIME CONTRACTS. IF EACH OF THESE PRIME CONTRACTS CONTAIN 25 TO 100 SUBCONTRACTS, THERE WOULD BE SEVERAL THROUSAND MAJOR SUBCONTRACTS. AND, THIS INCLUDES ONLY THE FIRST-TIER SUBCONTRACTS.

SUBCONTRACT PRICING INITIATIVES

IN JULY 1983, THE DoD INSPECTOR GENERAL ISSUED A DRAFT REPORT COVERING THEIR REVIEW OF THE EVALUATIONS OF MAJOR SUBCONTRACTORS'

BEST COPY AVAILABLE

PRICING PROPOSALS. AS A RESULT OF THE FINDINGS IN THE REPORT, THE DEPUTY SECRETARY OF DEFENSE ISSUED A MEMORANDUM DATED NOVEMBER 3, 1983 TO THE SERVICES AND DIRECTORS OF DEFENSE AGENCIES REEMPHASIZING THE DOD POLICY AND PROCEDURES WITH RESPECT TO THE PRICING OF MAJOR SUBCONTRACTS. SPECIFICALLY, THE MEMORANDUM COVERED (1) ACQUISITION PLANNING, (2) PREPROPOSAL EFFORT (ESTIMATING SYSTEMS, ACCOUNTING SYSTEMS, COST AND PRICING DATA REQUIREMENTS) (3) EVALUATION OF PROPOSALS, SPECIFICALLY THE PRIME CONTRACTOR'S RESPONSIBILITY IN EVALUATING SUBCONTRACTORS' PRICE PROPOSALS, AND (4) NEGOTIATION OF CONTRACT PRICE INCLUDING PRENEGOTIATION PRICE OBJECTIVES AND DOCUMENTATION OF NEGOTIATIONS.

MORE RECENTLY, WE INITIATED A REVIEW OF OUR CURRENT PROCEDURES FOR PRICING AND NEGOTIATING SUBCONTRACT PRICES. WE ARE PRIMARILY CONCERNED WITH TWO AREAS. FIRST, SHOULD WE CONTINUE OUR CURRENT PRACTICE OF NEGOTIATING WITH THE PRIME CONTRACTORS BEFORE THEY NEGOTIATE FIRM SUBCONTRACT PRICES, SECONDLY, SHOULD THE GOVERNMENT INCREASE ITS PARTICIPATION IN THE REVIEW OF SUBCONTRACTOR PRICE PROPOSALS THROUGH INCREASED AUDITS BY DCAA.

BASED ON INFORMATION PROVIDED TO US BY GAO REPRESENTATIVES DURING A DEBRIEFING ON THEIR AUDIT OF MAJOR SUBCONTRACTS, IT APPEARS THAT OUR ACTION TO DATE MAY NOT HAVE COMPLETELY RESOLVED ALL OF THE PROBLEMS. WE LOOK FORWARD TO THE RECEIPT OF THE COMPLETE GAO REPORT IN ORDER THAT WE MAY FURTHER ASSESS THE NEED FOR ADDITIONAL REGULATIONS IN THIS AREA.

ANOTHER SIGNIFICANT INITIATIVE UNDERWAY IS IN THE AREA OF SHOULD-COST REVIEWS. SHOULD COST REVIEWS ARE INDEPTH ANALYSES PERFORMED BY A GOVERNMENT TEAM AT THE CONTRACTORS' AND SUBCONTRACTORS' PLANTS. WE ARE CURRENTLY REVISING OUR REGULATIONS TO IMPROVE THE USE OF SHOULD-COST THROUGHOUT DOD. OUR REGULATIONS WILL ALSO EMPHASIZE THE USE OF SHOULD-COST IN EVALUATING PLANT-WIDE INDIRECT COSTS AND MAJOR SUBCONTRACTS.

CONTRACTOR PURCHASING SYSTEM REVIEWS

AFTER CONTRACT AWARD, GOVERNMENT CONTRACTING OFFICIALS MAINTAIN SURVEILLANCE OVER THE PRIME CONTRACTOR'S SUBCONTRACTING ACTIVITIES UNDER AUTHORITY CONTAINED IN THE "SUBCONTRACTS" CLAUSE OF THE PRIME CONTRACT. THIS CLAUSE REQUIRES THAT THE CONTRACTOR PROVIDE ADVANCE NOTIFICATION TO THE GOVERNMENT BEFORE AWARD OF CERTAIN SUBCONTRACTS AND REQUIRES CONTRACTORS TO OBTAIN THE CONTRACTING OFFICER'S WRITTEN CONSENT PRIOR TO ISSUING CERTAIN SUBCONTRACTS.

GENERALLY, IF THE CONTRACTOR HAS, OR EXPECTS TO HAVE, $10 MILLION OR MORE OF NEGOTIATED SALES TO THE GOVERNMENT IN A GIVEN YEAR, THE "SUBCONTRACTS" CLAUSE GRANTS US THE RIGHT TO PERFORM AN IN-DEPTH REVIEW OF ALL ASPECTS OF THE CONTRACTOR'S PURCHASING SYSTEM AND TO GRANT A FORMAL SYSTEM APPROVAL, IF WARRANTED. ONCE

APPROVAL IS GRANTED, WE RELY ON THE DAY-TO-DAY OPERATION OF THIS SYSTEM AND THE REQUIREMENT TO CONSENT TO INDIVIDUAL SUBCONTRACTS IS GREATLY REDUCED. HOWEVER, CONTINUOUS GOVERNMENT SURVEILLANCE IS MAINTAINED THROUGH PERIODIC RANDOM SAMPLING OF PURCHASE ORDERS AND FOLLOW-ON SYSTEM REVIEWS TO ENSURE THE SYSTEM CONTINUES TO OPERATE SATISFACTORILY.

BECAUSE OF THE RAPID GROWTH IN THE SCOPE AND COMPLEXITY OF SUBCONTRACTING UNDER DOD PRIME CONTRACTS, THE JOINT CONTRACT ADMINISTRATION COORDINATING COUNCIL HAS RECENTLY COMPLETED A COMPREHENSIVE REVIEW OF DOD'S SUBCONTRACTING MANAGEMENT POLICIES AND PROCEDURES. THE PRODUCT OF THIS EFFORT WILL SHORTLY BE SUBMITTED TO THE DAR COUNCIL FOR CONSIDERATION.

COMPETITION

INCREASING COMPETITION IS A MAJOR INITIATIVE IN DOD. HOWEVER, EVEN WHERE IT NECESSARY TO AWARD A CONTRACT BY OTHER THAN COMPETITIVE MEANS, OUR REGULATIONS REQUIRE THAT THE PRIME CONTRACTOR SHALL SELECT SUBCONTRACTORS ON A COMPETITIVE BASIS TO THE MAXIMUM PRACTICAL EXTENT. ACCORDINGLY, THE FAR CLAUSE AT 52.244-5, COMPETION IN SUBCONTRACTING, IS INCLUDED IN SUCH PRIME CONTRACTS VALUED AT $500,000 OR MORE.

BEST COPY AVAILABLE

UNALLOWABLE COSTS

THE DEPARTMENT OF DEFENSE SHARES THE SUBCOMMITTEE'S CONCERNS OVER SOME DEFENSE CONTRACTORS' PRACTICE OF CLAIMING REIMBURSEMENT FOR QUESTIONABLE AND, IN SOME CASES, EXPRESSLY UNALLOWABLE OVERHEAD COSTS. WE HAVE TAKEN A NUMBER OF POSITIVE STEPS TO CORRECT THIS PROBLEM. I WOULD LIKE TO HIGHLIGHT THESE ACTIONS FOR THE SUBCOMMITTEE.

(1) ON MARCH 5, AND 12, 1985, SECRETARY WEINBERGER DIRECTED THE SERVICES TO REVIEW CONTRACTOR BILLING RATES TO ASSURE THAT THEY WERE SET LOW ENOUGH TO PRECLUDE THE PAYMENT OF INAPPROPRIATE COSTS, EVEN ON AN INTERIM BASIS. HE ALSO DIRECTED THAT CONTRACTORS BE REQUIRED TO CERTIFY, UNDER THE PENALTY OF PERJURY, THAT CLAIMED OVERHEAD COSTS DO NOT INCLUDE COSTS THAT ARE UNALLOWABLE IN ACCORDANCE WITH OUR REGULATIONS. THIS IS A GENERAL TIGHTENING DOWN OF OUR REGULATIONS WHICH WAS THE CULMINATION OF ACTIONS UNDERWAY FOR SEVERAL MONTHS.

(2) ON DECEMBER 31, 1984, THE DEPUTY SECRETARY OF DEFENSE ESTABLISHED TEN PRINCIPLES OF OVERHEAD COST CONTROL. THE PRINCIPLES SET THE DIRECTION AND TONE OF FURTHER INITIATIVES FOR DEVELOPING BOTH CONTRACTOR INCENTIVES AND IMPROVEMENTS IN GOVERNMENT OVERSIGHT. ALSO, THE DECEMBER 31, 1984, MEMORANDUM ISSUED BY THE DEPUTY SECRETARY OF DEFENSE DIRECTED THE FOLLOWING ACTIONS WHICH ARE UNDERWAY:

58-931 O—86——7

o EACH SERVICE AND DLA WOULD CONDUCT A "SHOULD COST" REVIEW OF PLANT-WIDE OVERHEAD AT ONE CONTRACTOR LOCATION. THESE REVIEWS ARE NOW IN PROCESS.

o THE DEFENSE CONTRACT AUDIT AGENCY (DCAA) WOULD PERFORM A CENTRALLY DIRECTED AUDIT OF OVERHEAD ALLOCATION BASES USED BY THE MAJOR DEFENSE CONTRACTORS. THESE REVIEWS ARE BEING MADE TO ASSURE THAT OVERHEAD COSTS ARE ALLOCATED TO GOVERNMENT CONTRACTS ON A BENEFITS-RECEIVED BASIS. THERE MUST ALSO BE AN ASSURANCE THAT THE ALLOCATION METHODS USED TODAY HAVE KEPT PACE WITH THE CHANGING NATURE OF DEFENSE BUSINESS.

o THE RELATIONSHIP BETWEEN OVERHEAD AND THE DOD PROFIT POLICY WOULD BE EVALUATED UNDER THE DEFENSE FINANCIAL AND INVESTMENT REVIEW. ONE OF THE RECOMMENDATIONS OF THE REPORT WAS TO ELIMINATE GENERAL AND ADMINISTRATIVE (G&A) EXPENSES FROM THE BASE ON WHICH PROFIT IS TO BE COMPUTED. THIS CHANGE WOULD REMOVE ANY INCENTIVE THAT MAY EXIST IN THE CURRENT PROFIT POLICY FOR CONTRACTORS TO INCREASE THESE COSTS TO OBTAIN HIGHER PROFITS. ELIMINATING THE G&A FROM THE BASES WILL ALSO REDUCE THE COST-BASE PORTION OF PROFIT AND THEREFORE INCREASE THE INVESTMENT-BASED PORTION.

(3) SECRETARY WEINBERGER ESTABLISHED THE DEFENSE COUNCIL ON INTEGRITY AND MANAGEMENT IMPROVEMENT (DCIMI) WHICH IS CHAIRED BY

THE DEPUTY SECRETARY OF DEFENSE TO OVERSEE DOD ACQUISITION MANAGEMENT INITIATIVES AND IMPROVEMENTS. THE DCIMI HAS DIRECTED, AND EFFORTS ARE THEREFORE UNDERWAY TO:

o ASSEMBLE A TASK FORCE OF REPRESENTATIVES OF OSD, SERVICES, DLA AND DCAA, TO REVIEW ALL cost PRINCIPLES FOR THE PURPOSE OF IDENTIFYING AND CLOSING LOOPHOLES AND AMBIQUITIES.

o REVIEWS ALL EXISTING COST ACCOUNTING STANDARDS AND REVISE THOSE IN NEED OF CHANGE.

(4) ON AUGUST 5, 1985, THE DEPUTY SECRETARY OF DEFENSE ASSIGNED RESPONSIBILITY FOR FINAL OVERHEAD RATE DETERMINATIONS TO DCAA FOR ALL CONTRACTOR LOCATIONS. THIS EXTENDS THE SAME PROCEDURES CURRENTLY USED BY DCAA TO DETERMINE FINAL OVERHEAD RATES AT SMALLER CONTRACTORS TO THE LARGER CONTRACTOR LOCATIONS WHERE FINAL OVERHEAD RATES ARE CURRENTLY ESTABLISHED THROUGH ADMINISTRATIVE CONTRACTING OFFICER NEGOTIATION. NEW GUIDELINES ARE NOW BEING DEVELOPED TO IMPLEMENT THIS DECISION AT THE EARLIEST POSSIBLE DATE.

(5) THERE ARE A NUMBER OF OTHER ACTIONS THAT WE HAVE TAKEN THAT I WOULD LIKE TO BRING TO YOUR ATTENTION.

o A REVISION TO 31.205-19 "INSURANCE AND INDEMNIFICATION" WAS MADE ON APRIL 30, 1985, WHICH REDUCES THE AMOUNT OF COSTS THAT

MAY BE CHARGED TO GOVERNMENT CONTRACTS UNDER CERTAIN SELF-INSURANCE PROGRAMS.

o THE REQUIREMENTS OF COST ACCOUNTING STANDARD 405, ACCOUNTING FOR UNALLOWABLE COSTS, HAVE BEEN EXTENDED TO COVER ALL CONTRACTS, NOT JUST THOSE SUBJECT TO COST ACCOUNTING STANDARDS.

o A COST PRINCIPLE HAS BECOME EFFECTIVE THAT DISALLOWS LOBBYING COSTS AND POLITICAL CONTRIBUTIONS.

o A COST PRINCIPLE HAS BEEN PROMULGATED TO MAKE UNALLOWABLE THE LEGAL, CONSULTING, PROFESSIONAL AND OTHER COSTS ASSOCIATED WITH DEFENDING AGAINST CHARGES OF FRAUD OR OTHER IMPROPER ACTION.

O THE DEFINITION OF "REASONABLENESS" HAS BEEN REVISED TO ALLOW THE GOVERNMENT TO QUESTION THE REASONABLENESS OF OVERHEAD COSTS REGARDLESS OF THE AMOUNT OF COMMERCIAL BUSINESS A CONTRACTOR MAY HAVE. PREVIOUSLY, REASONABLENESS COULD NOT BE QUESTIONED WHERE A CONTRACTOR HAD A SUBSTANTIAL AMOUNT COMMERCIAL BUSINESS.

o A NEW COST PRINCIPLE ON "PUBLIC RELATIONS" HAS BEEN APPROVED BY THE DAR COUNCIL. IT WAS SENT TO THE CIVILIAN ACQUISITION COUNCIL (CAC) ON 23 SEP 85 FOR THEIR APPROVAL FOR PUBLICATION.

o A COST PRINCIPLE COVERING "TRAVEL COSTS" WAS APPROVED BY THE DAR COUNCIL ON SEPTEMBER 4TH. THE REVISION PRECLUDES

REIMBURSEMENT FOR CORPORATE AIRCRAFT UNLESS SPECIFICALLY REQUIRED BY CONTRACT.

o BASED ON A RECENT GAO RECOMMENDATION, WE ARE CHANGING OUR REGULATIONS TO PROVIDE THAT IF A COST IS FOUND TO BE UNALLOWABLE UNDER ONE COST PRINCIPLE, THAT COST CANNOT BE MADE ALLOWABLE UNDER ANOTHER COST PRINCIPLE.

IN ADDITION, THE DEFENSE ACQUISITION REGULATORY (DAR) COUNCIL IS PREPARING REVISIONS TO OTHER COST PRINCIPLES COVERING SUCH AREAS AS INSURANCE, COMPENSATION, "BANKED" VACATIONS, MERGERS AND ACQUISITIONS, AND EMPLOYEE DISCOUNTS.

AS YOU CAN SEE, WE HAVE ALREADY DONE A LOT OVER THE PAST FOUR YEARS TO BRING UNDER CONTROL EXCESSIVE, UNALLOWABLE OR IMPROPER CONTRACTOR OVERHEAD CHARGES. THE CORRECTIVE ACTIONS HAVE BEEN, FOR THE MOST PART, ALREADY SET IN MOTION. BUT WE ARE CONTINUALLY REVIEWING WHAT MORE WE CAN DO.

DEFECTIVE PRICING

THE TRUTH IN NEGOTIATION ACT, P.L. 87-653 AS IMPLEMENTED BY OUR REGULATIONS ENTITLES THE GOVERNMENT TO AN ADJUSTMENT OF THE NEGOTIATED CONTRACT PRICE, INCLUDING PROFIT, TO EXCLUDE ANY SIGNIFICANT SUM BY WHICH THE PRICE WAS INCREASED BECAUSE OF DEFECTIVE COST OR PRICING DATA. COST OR PRICING DATA ARE DEFECTIVE

IF SUCH DATA ARE NOT ACCURATE, COMPLETE AND CURRENT AS OF THE EFFECTIVE DATE OF THE CERTIFICATE OF CURRENT COST OR PRICING DATA.

THE GOVERNMENT'S RIGHT TO REDUCE THE PRIME CONTRACT PRICE EXTENDS TO CASES WHEN THE PRIME CONTRACT PRICE HAS INCREASED SIGNIFICANTLY BECAUSE A SUBCONTRACTOR FURNISHED DEFECTIVE COST OR PRICING DATA. IF ANY SUCH SUBCONTRACTOR DATA ARE SUBSEQUENTLY FOUND TO BE DEFECTIVE, THE PRIME CONTRACT IS SUBJECT TO PRICE ADJUSTMENT IN THE SAME MANNER AS WOULD BE THE CASE IF ANY OTHER COST OR PRICING DATA SUBMITTED BY THE PRIME CONTRACTOR PROVED TO BE DEFECTIVE.

A SIGNIFICANT FACTOR IN DOD'S IMPLEMENTATION OF P.L. 87-653, "TRUTH IN NEGOTIATION ACT," IS THE DOD POLICY THAT THE DEFENSE CONTRACT AUDIT AGENCY (DCAA) ESTABLISH AND CONDUCT A PROGRAM FOR REGULARLY PERFORMING SCHEDULED DEFECTIVE PRICING REVIEWS OF SELECTED CONTRACTS AND SUBCONTRACTS. AFTER DCAA PERFORMS A DEFECTIVE PRICING REVIEW OF A CONTRACT AND HAS REASON TO BELIEVE THAT DEFECTIVE DATA RESULTED IN A SIGNIFICANT INCREASE IN THE CONTRACT PRICE; THIS INFORMATION IS PROVIDED TO THE CONTRACTING OFFICER IN THE FORM OF AN OFFICIAL DCAA AUDIT REPORT.

THE NEXT STEP IN THE PROCESS IS FOR THE CONTRACTING OFFICER TO EVALUATE THE AUDIT REPORT TO DETERMINE IF THE GOVERNMENT IS LEGALLY ENTITLED TO A PRICE ADJUSTMENT. THE CONTRACTING OFFICER SHALL ALSO

COMPLY WITH THE REQUIREMENTS OF DOD DIRECTIVE 7640.2, FOLLOW-UP ON AUDIT REPORTS, IN RESOLVING DEFECTIVE PRICING AUDIT REPORTS.

WHEN THE CONTRACTING OFFICER CONCLUDES THAT DEFECTIVE PRICING EXISTS, A CONTRACT PRICE ADJUSTMENT IN THE AMOUNT BY WHICH THE DEFECTIVE DATA CAUSED AN INCREASE TO THE CONTRACT PRICE, IS REQUESTED OF THE CONTRACTOR. IF THIS IS NOT ACCEPTED BY THE CONTRACTOR AND THE CONTRACTOR FURNISHES ADDITIONAL INFORMATION THAT MAY NOT HAVE BEEN AVAILABLE TO THE CONTRACTING OFFICER IN REACHING HIS POSITION ON THE DEFECTIVE PRICING, THE CONTRACTING OFFICER WILL NORMALLY ATTEMPT TO NEGOTIATE A FAIR AND EQUITABLE SETTLEMENT WITH THE CONTRACTOR. AS IS THE CASE WITH MANY TYPES OF DISAGREEMENTS BETWEEN TWO PARTIES, THE UNDERLYING FACTS ARE NOT ALWAYS CLEARLY TO THE ADVANTAGE OF EITHER PARTY. IF THE PARTIES ARE UNABLE TO ARRIVE AT A MUTUALLY SATISFACTORY SETTLEMENT, THE CONTRACTING OFFICER WILL ISSUE A FINAL DECISION ON THE CASE. THE CONTRACTOR THEN HAS THE OPTION OF ACCEPTING THE FINAL DECISION OF THE CONTRACTING OFFICER'S STATED PRICE ADJUSTMENT OR MAY APPEAL THE DECISION TO THE ARMED SERVICES BOARD OF CONTRACT APPEALS OR FILE A SUIT AS PROVIDED BY THE CONTRACT DISPUTES ACT OF 1978 (P.L. 95-563). ISSUANCE OF A FINAL DECISION WITH THE POSSIBILITY OF SUBSEQUENT LITIGATION IS SOMETHING THAT IS NOT DONE IN DOD WITHOUT CAREFUL ANALYSIS AND JUDGMENT. WE RELY VERY HEAVILY ON OUR LEGAL COUNSEL THROUGHOUT THIS ENTIRE PROCESS. COUNSEL OFTEN ADVISES THE PCO THAT IT WOULD BE IN THE BEST INTERESTS OF THE GOVERNMENT TO NEGOTIATE A

SETTLEMENT RATHER THAN TO LITIGATE THE ISSUE DUE TO THE FACTS AND CIRCUMSTANCES INVOLVED IN THE CASE.

ONCE THE DEFECTIVE PRICING CASE IS SETTLED, OUR REGULATIONS REQUIRE THE CONTRACTING OFFICER TO PREPARE A MEMORANDUM ON THE AUDIT REPORT INDICATING HOW THE ISSUE WAS RESOLVED. A COPY OF THE MEMORANDUM IS FORWARDED TO THE AUDITOR ISSUING THE AUDIT REPORT AND TO THE COGNIZANT ADMINISTRATIVE CONTRACTING OFFICER.

I WOULD LIKE TO BRIEFLY TOUCH ON THE ACTIVITIES OF THE ARMED SERVICES BOARD OF CONTRACT APPEALS (ASBCA). THE BOARD ADJUDICATES CLAIMS RELATED TO CONTRACTS TO WHICH A MILITARY DEPARTMENT OR DEFENSE AGENCY IS A PARTY. THE BOARD, CONSTITUTED PURSUANT TO THE CONTRACT DISPUTES ACT OF 1978 OPERATES UNDER A CHARTER GRANTED JOINTLY BY THE SECRETARY OF DEFENSE, THE SECRETARY OF THE ARMY, THE SECRETARY OF THE NAVY, AND THE SECRETARY OF THE AIR FORCE. MEMBERS OF THE BOARD ARE ADMINISTRATIVE JUDGES WHO ARE CAREER CIVIL SERVANTS AND WHO ARE SELECTED ON THE BASIS OF MERIT. NOMINATIONS OF CANDIDATES FOR THE ASBCA ARE MADE BY BOARD MEMBERS FROM A REGISTER OF QUALIFIED CANDIDATES. NOMINATIONS ARE SUBMITTED THROUGH THE DEPARTMENT OF DEFENSE GENERAL COUNSEL TO THE APPOINTING OFFICIALS. AUTHORITY FOR MAKING THESE APPOINTMENTS WITH OSD WAS DELEGATED BY THE BOARD'S CHARTER TO THE ASD(A&L) AND TO THE ASSISTANT

SECRETARIES OF THE MILITARY DEPARTMENTS RESPONSIBLE FOR PROCUREMENT. UNDER THE CHARTER, THE CHAIRMAN AND VICE CHAIRMAN ARE APPOINTED OR REAPPOINTED FOR TWO-YEAR TERMS. REAPPOINTMENT IS CUSTOMARY. THE ASBCA CHARTER PROVIDES THAT THE BOARD SHALL HAVE ALL POWERS NECESSARY AND INCIDENT TO THE PROPER PERFORMANCE OF ITS DUTIES. THE BOARD ADOPTS ITS OWN METHODS OF PROCEDURE, AND RULES AND REGULATIONS FOR ITS CONDUCT AND FOR THE PREPARATION AND PRESENTATION OF APPEALS AND ISSUANCE OF OPINIONS. IT IS THE DUTY AND OBLIGATION OF THE MEMBERS OF THE ASBCA TO DECIDE APPEALS ON THE RECORD OF THE APPEAL TO THE BEST OF THEIR KNOWLEDGE AND ABILITY IN ACCORDANCE WITH APPLICABLE CONTRACT PROVISIONS AND IN ACCORDANCE WITH LAW AND REGULATIONS PERTINENT THERETO.

PL 87-653, TRUTH IN NEGOTIATION ACT, WHILE PROVIDING THE GOVERNMENT WITH THE RIGHT TO A CONTRACT PRICE ADJUSTMENT UNDER CERTAIN CONDITIONS, WAS PRIMARILY INTENDED TO AVOID OVERPRICING BY ASSURING THAT THE GOVERNMENT HAS EQUAL KNOWLEDGE OF FACTS AFFECTING CONTRACT PRICING. A SUMMARY OF ACTIONS TAKEN TO STREGHTEN THE LAW, AND INITIATIVES BY DOD ARE AS FOLLOWS:

(1) THE CONGRESS LOWERED THE THRESHOLD FROM $500,000 TO $100,000 FOR REQUIRING CERTIFIED COST OR PRICING DATA. THIS CHANGE WAS EFFECTIVE IN OUR REGULATIONS AS OF APRIL 1, 1985.

(2) ON JULY 25, 1985, BY DEFENSE ACQUISITION CIRCULAR (DAC) NO. 84-12, THE DOD LOWERED THE THRESHOLD FROM $500,000 TO $100,000

FOR THE REQUIREMENT OF THE CONTRACTING OFFICER TO OBTAIN A FIELD PRICING REPORT ON FIRM FIXED-PRICE PROPOSALS. THE THRESHOLD WAS LOWERED TO $250,000 FOR FIXED PRICE INCENTIVE CONTRACTS. ALSO, THE CONTRACTING OFFICER COULD NO LONGER WAIVE THE REQUIREMENT FOR A FIELD PRICING REPORT BY HIS OWN AUTHORITY. ANY WAIVER MUST NOW BE APPROVED IN WRITING AT A LEVEL ABOVE THE CONTRACTING OFFICER.

(3) DAC 84-12 REVISED SUBPART 15.8 OF OUR REGULATIONS TO REQUIRE THAT CONTRACTING OFFICERS KEEP AUDITORS INFORMED OF PLANNNED PRENEGOTIAATION AND NEGOTIATION ACTIVITIES, AND INVITE CONTRACT AUDIT PARTICIPATION WHERE A SIGNIFICANT CONTRIBUTION CAN BE MADE.

(4) THE DAR COUNCIL IS CONSIDERING A CHANGE TO THE REGULATIONS TO PROVIDE FOR RECOVERY OF INTEREST ON DEFECTIVE PRICING OVERPAYMENTS.

(5) THE DAR COUNCIL IS CONSIDERING FURTHER STRENGTHENING OUR REGULATIONS TO REQUIRE THAT AUDIT REPORTS BE FREE OF ANY SIGNIFICANT QUALIFICATIONS DUE TO CONTRACTOR'S DENIALS OR DELAYS IN PROVIDING SUPPORTING DOCUMENTATION AND RECORDS.

(6) ON APRIL 19, 1985, WE ISSUED DIRECTION TO THE SERVICES, DLA AND DCAA THAT PROHIBIT CONTRACTING OFFICERS FROM ENTERING INTO FORMAL AGREEMENTS TO RESTRICT THE ACCESS BY DCAA AUDITORS TO SELECTED CONTRACTORS' RECORDS.

(7) A DAR CASE WAS INITIATED ON JUNE 28, 1985, TO REQUIRE THAT A FIELD PRICING REPORT SHALL INCLUDE A DCAA AUDIT REPORT.

(8) ON JUNE 21, 1985, A MEMORANDUM WAS ISSUED TO DOD COMPONENTS TO REQUIRE THAT CONTRACTORS RECORD ACTUAL COSTS IN A MANNER THAT IT CAN BE USED IN FOLLOW-ON CONTRACT NEGOTIATIONS AND IN THE DEFINITIZATION PROCESS FOR LETTER CONTRACTS AND UNPRICED ORDERS.

(9) DOD INSPECTOR GENERAL AUDIT REPORT NO. 85-109, "CONTRACTING OFFICER DECISIONS ON CONTRACT AUDIT RECOMMENDATIONS" ISSUED ON AUG 16, 1985, STATED THAT CONTRACTING OFFICERS RECOVERED A SIGNIFICANT AMOUNT OF COSTS QUESTIONED BY DCAA. IN FACT, THE AUDIT REPORT STATED THAT CONTRACTING OFFICERS SUSTAINED 75% OF THE COSTS QUESTIONED BY DCAA. ONE OF THE PRIMARY OBJECTIVES OF THE AUDIT WAS TO DETERMINE THE EXTENT TO WHICH CONTRACTING OFFICERS IMPLEMENTED CONTRACT AUDIT RECOMMENDATIONS. THE AUDIT COVERED A CROSS-SECTION OF ALL AUDIT REPORTS WHERE DCAA HAD QUESTIONED $1,000 OR MORE. IT INCLUDED AUDITS OF DEFECTIVE PRICING, INCURRED COSTS (INCLUDING INDIRECT EXPENSE RATES), COST ACCOUNTING STANDARDS, PREAWARD AUDITS, ETC. THE REPORT ALSO REFLECTED THAT SIGNIFICANT RECOVERIES ON DEFECTIVE PRICING AUDITS HAD BEEN ACHIEVED IN 75 PERCENT OF THE CASES INCLUDED IN THE AUDIT SAMPLE. ON THE OTHER 25 PERCENT, THE AUDITORS BELIEVED THAT BETTER RESULTS COULD HAVE BEEN ACHIEVED IF CONTRACTING OFFICERS HAD RELIEVED MORE ON LEGAL ASSISTANCE AND IF THEY HAD BEEN BETTER TRAINED IN DEFECTIVE

PRICING. WE HAVE ISSUED GUIDANCE TO DOD COMPONENTS TO INSURE THAT THEIR INTERNAL PROCEDURES IMPLEMENT BOTH OF THESE RECOMMENDATIONS. DESPITE THE FACT THAT THIS RECENT DOD INSPECTOR GENERAL AUDIT REPORT SHOWS THAT CONTRACTING OFFICERS SUSTAINED 75 PERCENT OF COSTS QUESTIONED BY DCAA, WE WILL CONTINUE OUR REFORM EFFORTS IN THIS RESPECT. WE DO, HOWEVER, BELIEVE THIS AUDIT REPORT SHOWS A POSITIVE TREND OF IMPROVEMENT.

(10) I ALSO SUPPORT THE CONGRESSIONAL REFORMS TO STRENGTHEN THE TRUTH IN NEGOTIATION ACT AS DOES SECRETARY WEINBERGER. WE BELIEVE THE PROPOSED CHANGES NOW UNDER CONSIDERATION BY THE CONGRESS WILL HELP TO BOTH AVOID DEFECTIVE PRICING, AND IMPROVE OUR ABILITY TO RECOVER FUNDS WHERE DEFECTIVE PRICING IS DISCOVERED.

ESTIMATING SYSTEMS

THE POLICY WITH REGARD TO ESTIMATING SYSTEMS IS INCLUDED IN FAR 15.811. THE DCAA AUDIT ACTIVITIES ESTABLISH AND MANAGE REGULAR PROGRAMS FOR REVIEWING SELECTED CONTRACTORS' ESTIMATING SYSTEMS OR METHODS, IN ORDER TO (1) REDUCE THE SCOPE OF REVIEWS TO BE PERFORMED ON INDIVIDUAL PROPOSALS, (2) EXPEDITE THE NEGOTIATION PROCESS, AND (3) INCREASE THE RELIABILITY OF PROPOSALS. THE RESULTS OF ESTIMATING SYSTEM REVIEWS ARE DOCUMENTED IN SURVEY REPORTS. SIGNIFICANT DEFICIENCIES NOT CORRECTED BY THE CONTRACTOR SHALL BE A CONSIDERATION IN SUBSEQUENT PROPOSAL ANALYSES AND

NEGOTIATIONS. THE CONTRACTING OFFICER HAS THE FINAL RESPONSIBILITY TO INSURE THAT SIGNIFICANT DEFICIENCIES ARE CORRECTED.

FAR 15.811 (C) LISTS SIX MAJOR ITEMS TO BE CONSIDERED IN DETERMINING THE ACCEPTABILITY OF A CONTRACTOR'S ESTIMATING SYSTEM AS FOLLOWS:

(1) THE SOURCE OF DATA FOR ESTIMATES AND THE PROCEDURES FOR ENSURING THAT THE DATA ARE ACCURATE, COMPLETE, AND CURRENT;

(2) THE DOCUMENTATION DEVELOPED AND MAINTAINED IN SUPPORT OF THE ESTIMATE;

(3) THE ASSIGNMENT OF RESPONSIBILITIES FOR ORIGINATING, REVIEWING, AND APPROVING ESTIMATES;

(4) THE PROCEDURES FOLLOWED FOR DEVELOPING ESTIMATES FOR DIRECT AND INDIRECT COST ELEMENTS;

(5) THE EXTENT OF COORDINATION AND COMMUNICATION BETWEEN ORGANIZATIONAL ELEMENTS RESPONSIBLE FOR THE ESTIMATE; AND

(6) MANAGEMENT SUPPORT, INCLUDING ESTIMATE APPROVAL, ESTABLISHMENT OF CONTROLS, AND TRAINING PROGRAMS.

MR. CHAIRMAN, THIS CONCLUDES MY STATEMENT.

BEST COPY AVAILABLE

ADDITIONAL QUESTIONS OF MR. BROOKS
FOR DR. WADE

Q. 1. Your statement indicates that contracting officers may request audits or field pricing support to evaluate the proposal of a subcontractor at any tier if he believes it is needed to insure reasonableness of the prices.

(a) Please provide information on the frequency with which this procedure is followed by contracting officers.

(b) Please cite some examples where the procedure was followed below the first tier subcontractor.

(c) Who in DoD has responsibility for determing whether prime contractors are doing a good job in evaluating subcontract price proposals? Discuss how this responsibility is carried out, especially below the first tier subcontractor level.

A. 1.(a)&(b) Detailed information of this nature is not maintained by OSD. It would require a review of each contract file to obtain the information.

1.(c) The contracting officer has the primary responsibility for determining whether prime contractors did a good job in evaluating subcontract price proposals for both the first tier subcontracts and for lower tier subcontracts.

Q. 2. How many "should cost" reviews have been conducted as a result of the December 31, 1984, memorandum issued by the Deputy Secretary of Defense directing such reviews? Identify them and provide information describing how some of these have contributed to better pricing.

A. Five should cost studies are being conducted. The contractors involved are Hughes, Grumman, Lockheed, General Dynamics and Magnavox. The should cost results will be used to assist in the negotiations of contracts with these companies.

Q 3. When will the cost principles disallowing lobbying costs, political contributions, and legal, consulting and other costs associated with defending against charges of fraud become effective?

A.

Cost Principle	Date Published
Lobbying Cost (including political contributions)	On October 20, 1982, DAR 15-205.51 made lobbying costs unallowable. On April 27, 1984, the successor cost principle in FAR 31.205-22 made political contributions specifically unallowable.

BEST COPY

Defense of Fraud Proceeding (legal, consulting and other associated costs)	On October 20, 1982, DAR 15-205.52 was added to make these costs unallowable where the contractor is convicted (now FAR 31.205-47).

Q. 4. How long has the DAR Council been considering a change in regulations to provide for recovery of interest on defective pricing overpayments? What is the timetable for completion of action on this issue?

A. The DAR case was originated on May 1, 1984. We plan to forward the coverage to the Civilian Acquisition Council within 60 days.

Q 5. What is the purpose of the proposal to require audit reports to be free of any significant qualifications due to contractors' denials or delays in providing support records? How will this strengthen regulations?

A. The purpose of this proposed change to our regulations is to help ensure that the auditor has timely access to contractors' supporting records. This will strengthen our regulations in that a contracting officer will not have the authority to negotiate a contract when there is a significant qualification in the audit report.

Q. 6. Please provide a breakdown of the 75 percent rate that contracting officers achieved in sustaining cost questioned by DCAA. That is, what were the rates separately for defective pricing reviews, preaward proposal audits, incurred costs audits, and any other category employed?

A.

CATEGORY	PERCENT SUSTAINED
Preward	100
Cost Accounting Standards	73
Defective Pricing	33
Incurred Cost (including indirect expense rates)	88
Operational Audits	57
Price Redeterminations	21
Terminations	100
Other	100

Q. 7. GAO found that adequate reviews were not being made of contractor cost estimating systems. One of the problems noted was that the reviews performed are fragmented. Another problem was that technical and engineering personnel are not utilized for this purpose.

Why are reviews not performed on the entire cost estimating system, utilizing auditors and technical personnel?

A. DCAA is assigned overall responsibility for auditing contractor cost estimating systems. System improvements needed are reported to the cognizant administrative contracting officer (with distribution to acquisition offices doing business with the contractor) for pursuit of corrective action. These audits are continuous. While major contractors are the subject of a formal system-wide audit when they become major contractors and when significant organizational or procedural changes occur, the system-wide audit is not otherwise repeated. Audit attention is given, instead, to those elements of the system reviewed as an integral element of other audits. For example, individual price proposal audits, defective pricing audits, and overhead audits all contribute to the information needed to evaluate the cost estimating system. The audit findings are accumulated for the contractor as a whole and system deficiency reports are issued when significant. It is the absence of a repetitive system-wide review which appears to have lead to the GAO misunderstanding.

While there is an adequate review of contractor cost estimating systems, there is room for improvement. DCAA has recently established an action plan to improve in this area (i.e., guidance emphasizing the priority of system audit reports and requesting additional resources--overtime and staffing). Since there are times when technical personnel may not be available to provide assistance during audits, DCAA has established an action plan to address this problem. Job Opportunity Announcements have been distributed for a small engineering staff to serve in technical liaison positions within DCAA. Their function will be to develop a more efficient means of identifying specific audit questions requiring responses by technical personnel and to develop recommendations for improving the acquisition process by assuring that adequate technical assistance will be provided during contract audits.

Mr. BROOKS. Mr. Saxton.

Mr. SAXTON. Mr. Secretary, do you have a system through which contracting officers are evaluated in terms of how they perform their assigned duties?

Dr. WADE. Everybody in the Government has a process behind him of how he's evaluated. I can't go into detail on this, but, yes, obviously there is.

Mr. SAXTON. Does that system of evaluation perhaps include the effectiveness with which the individual has contracts approved or negotiated, or the period of time it may take him or her to perform that function?

Mr. KENDIG. Sir, it would include all of those factors, both the manner and efficiency with which he negotiated the contract, the timeliness of it. So, you know——

Mr. SAXTON. Would you say there is any pressure put on a contracting officer to get his job done quickly?

Mr. KENDIG. There is pressure put on all of us to get our jobs done quickly, in many instances due to our appropriations process. It is not something we can avoid. We are charged with the fact that there are many times that we are faced with funds that will expire, and therefore those contracts must be negotiated before they expire.

So, we do have that problem. Now when we are not talking about funds that are about to expire, there is not a pressure to get it done quickly in order to meet some arbitrary date or deadline.

Mr. SAXTON. What I'm trying to get at is that a part of the system appears to be—there has been at least some criticism levied against these individuals for perhaps having to take shortcuts in order to get their jobs done in a timely fashion.

Is that a valid criticism from your point of view?

Dr. WADE. Oh, I think probably in some cases that will happen, but I don't think overall. I think the answer to your question is yes and no. I mean, Americans like to solve problems, and we like to solve our problems and get on with our jobs in the speediest fashion, and I think that's a good approach to it, to the matter, because any time you stretch anything out as far as your procurement is concerned, it costs you money in its own right.

The real issue here is the balance between making sure that you have the right data, sit down and negotiate the right proposal, and feel satisfied that you're doing the right job in the context of producing a quality product, which I think is an important aspect here, at an affordable, good price to the Government. And if it takes more time, then we should take more time.

But understand also, there is a need to face an external threat, and that external threat changes over time also. Yes and no is the right answer.

Mr. SAXTON. Yes and no.

Mr. BROOKS. Thank you, Mr. Saxton.

Do you think, Mr. Secretary, that the actions taken by the DOD regarding unallowable costs will solve the problems identified?

Dr. WADE. Mr. Chairman, I believe the answer is, in the main, yes. These have been positive steps.

Mr. BROOKS. But partially no?

Dr. WADE. Well, I think——

Mr. BROOKS. In the main, yes, but partially no.

Dr. WADE. No, sir. The answer is yes. Working together with the Congress in reference to future legislation is going to help further.

We have taken actions which I think are a major step forward. I think, in the main, they're going to solve virtually all the problems, but I can't guarantee 100 percent. I think we're going to find further changes in the future. But as of now, these have been solid, very constructive steps forward.

Mr. BROOKS. But you are going to promulgate something for the regulations on that?

Dr. WADE. There will be regulations following each one of these procedures; yes, sir.

Mr. BROOKS. Have you done that yet?

Dr. WADE. In most of these cases, we have.

Mr. BROOKS. Would you give us a list of those that you have promulgated and those that you have regulations out on?

Dr. WADE. Yes, sir.

Mr. BROOKS. You know, the Federal accquisition regulation has the public relations costs, loopholes, and so forth, and a lot of statements on it, but have you got a regulation out on each one of those?

Dr. WADE. Yes, sir, I will.

Mr. BROOKS. Let me have a list of those you have.

[The information follows:]

1. DAC 76-31, October 30, 1981
   Prohibition on Recovery of Lobbying Costs.

2. DAC 76-33, February 15, 1982
   Application of Cost Accounting Standard 405 to all negotiated defense contracts.

3. DAC 76-37, August 5, 1982
   Relocation Costs.

4. DAC 76-39, October 20, 1982
   Lobbying Costs amended to make the cost of all lobbying activities in connection with any legislative body unallowable.

5. DAC 76-39, October 20, 1982
   Defense of Fraud Proceeding.

6. DAC 76-43, March 22, 1983
   Compensation for Personnel Services.

7. DAC 76-45, June 30, 1983
   Contractors Weighted Average Share (CWAS) In Cost Risk Program was eliminated.

8. DAC 76-48, January 25, 1984
   Goodwill made unallowable.

9. Revised FAR 31.205-19, April 30, 1985
   Insurance and Indemnification.

10. FAR 31.205-1, Approved for Publication, September 23, 1985.
    Public Relations and Advertising Costs was forwarded to Civilian Acquisition Council.

11. FAR 31.205-46, September 4, 1985
    Travel Costs, sent to Civilian Acquisition Council for approval and publication.

12. DoD FAR Supplement, March 21, 1985
    Certification of Overhead Costs.

Mr. BROOKS. In light of what you've heard during this hearing—and you all are gracious to stay here and attend and to listen—what are you going to do with regard to obtaining refunds? Just the general problem, how are you going to get our money back from the contractors for defective pricing and for overpricing?

You know, we are leaving a lot on the table. Obviously DOD ought to get it or get most of it back from those contractors.

Now are you going to do that?

Dr. WADE. Well, Mr. Chairman, in every case where either overpricing or defective pricing has been indicated and we have the legal right to go back and get our funds back, we're going to do that. I think in those cases——

Mr. BROOKS. Prospectively you're going to. But are we doing it now?

Dr. WADE. Yes, sir. Yes, sir.

I think in those cases where there might not be a legal right, then we ought to go back and work the voluntary right.

Mr. BROOKS. The voluntary?

Mr. KENDIG. Asking the contractors for voluntary refunds.

Mr. HORTON. Do what, sir?

Mr. KENDIG. Asking the contractor for a voluntary refund when something is identified as excessive pricing, a practice that Secretary Weinberger has pushed very hard over the last year. It is something that is being done, and we have had some success in that area.

Mr. BROOKS. Mr. Kendig, you know my own personal theory about voluntary refunds, though.

Mr. KENDIG. No, sir, I don't yet.

Mr. BROOKS. You might suspect, I'm a little doubtful. It is my theory that when somebody offers voluntarily to give you $1 million to settle a case, it means that the case was worth $10 million, you know. I just always have the feeling that it's about a 10-to-1 guilt on what they offer you, and generally they get away with it.

And we finally did some of that in computers. About 20 years ago, I got them to do that. But we have not done it on defense contracting, because items change. But the principle is the same. As a buyer of a large quantity of this material, 300 billion dollars' worth, we ought to get better prices for our weapon systems.

You all work on it after the contract has been awarded. But the contracting officers are the people who need to efficiently manage Government money like their own.

Dr. WADE. I think your point is correct in the main, Mr. Chairman. Where you have a sound contract with all of the legal pieces in it, that is the best way. Certainly voluntary refunds——

Mr. BROOKS. Oh, I wouldn't turn it down, because I don't think we have the guts to sue them in many instances.

Dr. WADE. But also by going to the top of the corporation and pointing out to him where mistakes or misuse of the process is shown to be true, then you expect that he will take the right thing, and if he doesn't, I think that's an issue——

Mr. BROOKS. Well, some of them have a corporate image that they're trying to maintain as being exemplary.

Dr. WADE. Yes, sir. We find, for example, mentioning these kinds of processes or procedures in the newspaper is something they don't want. So that has its own——

Mr. BROOKS. Well, it is just one of the tools, and I wouldn't turn it down. But I sometimes think we leave a whole lot on the table, and I think that the recourse after what the contracting officer signs off on is really difficult to pursue.

Once the contracting officer signs off, it looks to me like the prime contractors are home free. On overcharging, he can just nail you to the wall, high as he can get you, and tell you, "Well, the contracting officer signed off, for whatever reason I don't know."

I realize that many contracting officers do a great job, a magnificent tremendous job for the country. However, maybe there are some of them who make mistakes. I don't mean many of them, but DOD ought to go behind that and collect the money the contracting officer left on the table by permitting contractor overpricing.

Mr. Horton, did you have comments you wanted to make? We're glad to have you here, and we appreciate your basic understanding and contribution to this hearing and these proceedings.

Mr. HORTON. Mr. Chairman, I'm sorry I couldn't be here earlier. I had a direct conflict with another meeting, a committee hearing that I had to attend.

I am very much interested, though, in this subject. I do have a statement which I would like to ask unanimous consent to——

Mr. BROOKS. Oh, it's in the record.

Mr. HORTON. Oh, it's already in?

Mr. BROOKS. Oh, yes. We thank you very much.

Mr. HORTON. Dr. Wade, I have some questions that I will submit to you in writing for your answers. Thank you.

[Dr. Wade's submissions to questions of Mr. Horton follow:]

QUESTIONS OF MR. HORTON
FOR DR. WADE

Q. Congressman Horton. Excess payments under negotiated contracts, combined with the costs to the government in trying to assure fair and honest pricing in the absence of competition, clearly adds up to a significant amount of money.

a. Do you agree that stimulating greater competition for the business being done by DoD would offer real savings over the evident inefficiencies of managing non-competitive acquisitions?

b. Given DoD's apparent willingness to spend considerable sums on acquisition management, wouldn't it be better to pay the extra money to help build a broader competitive base instead, so that in time, competitive prices will result and the burden of cost and pricing data on both DoD and industry can be relieved?

A. a. Yes, we believe greater savings can be achieved through increased competition.

b. It is DoD's goal to broaden the competitive base to the maximum extent possible. However, we believe there will always be a requirement for single source procurements where cost or pricing data are required.

Q. 2. GAO has mentioned an initiative taken on August 5 by the Deputy Secretary of Defense which is described as assigning responsibility for overhead cost settlements to the Defense Contract Audit Agency.

2(a). What improvements are expected from relying on "auditor determination procedures" instead of past procedures?

2(b). Does the change take account of the provision in the Conference Report on the FY 1986 DoD authorization bill, designed to eliminate "botton line" negotiations on overhead payments?

2(c). Will the change require additional or reduced DCAA resource devoted to audits of incurred costs?

A. 2(a). DCAA auditors are highly skilled in the area of allocability, allowability and reasonableness of overhead costs whereas contracting officers have a general working knowledge of this area. Therefore, we believe that the auditors are in a position to accomplish the task of overhead cost settlements in an effective manner.

2(b). We are currently working out the detailed procedures. This issue will be addressed as a part of this process.

2(c). The change will not affect the resources devoted to audits of incurred costs. An audit is performed in either case.

Q. 3. GAO found that lack of required evaluations of subcontract pricing proposals results from one of three contractor deficiencies:

- Misclassification of subcontracts as competitive, and therefore as not requiring an evaluation.
- Performance of the evaluation too late to be used in negotiations with the government.
- Failure to perform any evaluation at all.

(a) Which seems to be the most significant cause?

(b) What steps would you support to eliminate these deficiencies?

A. 3(a). We do not have a copy of the GAO report that contained this breakdown. Therefore, we are unable to state which is the most significant cause.

3(b). We believe our current regulations, when followed, will prevent these deficiencies from occurring.

Q. 4. Confronted with a negotiating situation in which the prime contractor has not provided a useful evaluation of subcontractor pricing proposals, the contracting officer may take a number of steps to protect the government's interests:

- Have the evaluation redone by the contractor;
- Have the government auditors perform an evaluation;
- Seek a contract that includes a reservation on subcontracts at issue to permit downward pricing in the future;
- Make no award.

Under what circumstances would you find it reasonable for a contracting officer to pass up all of these options and proceed to negotiate a fixed-price contract?

A. There are no circumstances where we would find it reasonable for a contracting officer to pass up the options listed in FAR 15.804-6(i), which includes those options above, and proceed to negotiate a fixed-price contract when an adequate evaluation of a subcontractor price proposal has not been accomplished.

Q. 5. GAO's review did not include as assessment of estimating systems being used by DoD contractors.

(a) Has the Department of Defense conducted such an assessment?

(b) What elements of contractor estimating systems do you believe should be standardized?

(c) Are there drawbacks to attempting standardization of this sort?

A. 5(a) The DCAA audit activities establish and manage regular programs for reviewing contractors' estimating systems.

5(b) The word "standardized" as used in this question implies that estimating systems for various companies should be uniform. We do not believe this to be appropriate. Estimating systems should be developed to meet the particular needs of a company. However, the cost accounting standards place certain restrictions and requirements on estimating systems. For example, a contractor is required to estimate costs in a manner consistent with the way the company records actual costs.

5(c) Yes, as stated in the answer to Question 5(b), estimating systems must be tailored to meet the needs of a particular company.

Q. 6. GAO has found that responsibility is unclear for resolving estimating deficiencies.

(a) Do you agree with GAO that this responsibility should reside with the administrative contracting officer?

(b) Do you share the view of procurement contracting officers, as reported by GAO, that the adverse effects of estimating deficiencies are mitigated by contract auditors' reviews of price proposals?

(c) In bringing necessary management attention to this area, will you provide guidance necessary to establish better follow-up on identified estimating deficiencies?

A. 6(a) The administrative contracting officer has the primary responsibility for resolving estimating system deficiencies. However, FAR 15.900(b) provides that significant deficiencies not corrected by the contractor shall be a consideration in subsequent proposal analyses and negotiations. The DoD FAR Supplement provides that in such cases, the PCO shall assure that corrective action is initiated prior to the award of the contract.

6(b) Yes, once the entire estimating system has been evaluated, a review of the estimating procedures for a particular proposal is an effective approach.

6(c) Yes, this will be done after we receive and evaluate the GAO report.

Q. 7. Many of the recommendations we have heard today signify a growing workload for contract auditors.

Does DoD plan to provide additional resources for these purposes?

A. Yes, 485 spaces were added in FY 1985 and 227 more will be added in FY 1986. Additional requirements will be proposed in later years.

Q. 8. DCAA's defective pricing audit coverage for the last 2 years has recommended downward price adjustments totalling less than 1% of the contract dollars reviewed. Similarly, GAO's findings of overpricing due to non-disclosure on 30 subcontract cost estimates constituted less than 1% of those cost estimates.

(a) Do you believe these findings are indicative of the incidence of defective pricing?

(b) Do these findings lead you to take any differenct view from the IG's with regard to defective pricing audit requirements and the expected benefits from added emphasis in this area?

A. 8(a) We believe that DCAA audits are indicative of the incidence of defective pricing. For example, during 1985 DCAA reviewed contracts valued at $79 billion for defective pricing. The recommended price adjustments made based on these audits totaled $640 million which is less than 1% of the value of contracts audited.

8(b) Due to the magnitude of the dollars questioned by DCAA in 1985 ($640 million) we agree that the increased DCAA resources devoted to defective pricing reviews is appropriate.

Q. 9. The Conference Report on the FY 1986 DoD Authorization Bill contains a section directing the Secretary of Defense to issue regulations that establish the allowability or unallowability of overhead costs in a range of specified areas.

(a) In comparing the provisions of that bill with existing regulations, do you find any areas not presently addressed in the Federal Acquisition Regulation (FAR)?

(b) Do you believe changes to the existing cost principles will be necessary if this provision becomes law?

(c) If so, in what areas?

A. 6(a) For the most part, our regulations currently provide that these costs are not allowable. We will, however, need to make minor adjustments to our cost principles. For example, the authorization bill makes unallowable the costs

for travel by commercial aircraft which exceed the amount of the "standard" commercial fare. Our regulations provide that the difference between first class airfare and less than first class airfare is unallowable.

6(b) Yes, as stated in 6(a) above, we will have to make minor adjustments to the cost principles.

6(c) The cost principles at FAR 31.205-15 (Fines and Penalties) and 31.205-46 (Travel Costs) will require minor changes. The provision that makes cost of alcoholic beverages unallowable may affect several cost principles; such as, travel costs and entertainment. As currently written, the provision to make unallowable the costs of alcoholic beverages may require some clarification. For example, this provision would make unallowable the cost of a glass of wine that a traveler might have with a meal.

Q. 10. Please give an example of "follow-on" savings to the government that you say would result from situations in which a prime contractor strikes a lower-than-expected price with his subcontractors.

What proportion of non-competitive awards are made in a manner that would take advantage of such savings?

A. The government benefits if the prime contractors are able to negotiate lower prices with the subcontractors. If the prime contract is an incentive type contract, the government will share in the savings on the instant contract. If the prime contract is firm fixed-price, the government will realize the full savings on any follow-on contracts. The follow-on savings also apply to incentive contracts. We do not have a reporting system that measures such savings on follow-on procurements. Such a system would be very expensive due to the magnitude of data that must be reviewed and resources required to maintain a reporting system.

Q. 11. A memorandum written last year by DoD's Comptroller took note of allegations and occassional indictments involving subcontractor kickbacks to defense contractors.

How extensive a problem do you believe this is?

A. Based on available information, we do not believe the problem to be extensive. However, the Department is concerned and has increased the emphasis to detect such irregularities.

Q. 12. If a prime contractor negotiates subcontracts before signing a contract with the government, subcontractors are in a stronger bargaining position and seem likely to win awards at prices higher than otherwise. On the other hand, if subcontracts are signed after negotiations with the government have been completed, the prime contractor is in a stronger bargaining position in relation to his subcontractors, and the prime seems likely to get the greater benefit of favorable terms.

Has there been any evidence to suggest that the cost to the government is consistently greater under one procedure or the other?

A. There is no way to determine for certain that the cost to the government is greater under one procedure or the other. However, the prime contractors have a monetary incentive to negotiate subcontract prices lower than were negotiated with the government because they will share in any resultant savings. The government also benefits as stated in the response to Question 10.

Q. 13. Earlier this year, the Secretary of the Air Force requested both General Electric and United Technologies to make a voluntary refund under fixed price contracts because those companies had realized profits under those contracts which the Inspector General found to be significantly in excess of what had been negotiated.

(a) In cases of the sort we have been hearing about today, in which defective pricing is not indicated, would you support requests for voluntary refunds?

(b) (If not), Are there significant differences between the above cases and those we have heard about today?

(c) What is the difference between excess profit, as found by the IG for GE and UT, and the enrichment that may follow from lowering subcontract prices?

A. 6(a) We will review the facts and circumstances under each contract where the GAO found overpricing. Based on this review, a decision will be made in line with Secretary Weinberger's policy of requesting refunds where we have been overcharged.

6(b) See response to 6(a).

6(c) The principal issues are the same. In one case the contractor was able to perform the contract for less than was negotiated because inflation was less than projected and the contractor was able to manufacture the items ahead of the projected delivery schedule. In the case of the subcontracts, the prime contractors were able to negotiate lower subcontract prices than were included in the price of the prime contract negotiated with the government.

Q. 14. The various incentive award programs conducted by the Services can potentially make important contributions toward eliminating unnecessarily high prices for military items.

(a) Do these programs extend to contractors and subcontractors (referred to jointly in the following questions as "contractors")?

(b) If so, how many contractors have received such awards?

(c) In the last year for which data is complete, what was the total value of (1) estimated savings from contractors' suggestions, and (2) the resulting awards made to them?

(d) How is the amount of such an award determined?

A. 14(a) No, the programs do not extend to contractors and subcontracts.

14(b) N/A

14(c) N /A

14(d) N/ A

Q. 15. "Windfall profits" resulting from inadequate review of subcontractor pricing proposals may constitute less than the persisting problem of excessively-priced spare parts. Legislation last year and subsequent initiatives within DoD have mandated the "break-out" of spare parts purchases from prime contractors; yet I continue to receive reports of stock item replacement parts being acquired on a sole-source basis from prime contractors.

(a) With reference to the terms of 10 U.S.C. 2319(c)(3), as added by the FY 1985 DoD Authorization Act, is there any situation in which a subcontractor who is the existing item manufacturer and who owns the related technical data could be excluded from making an offer to compete with his prime contractor for the business of providing replenishment spares directly to DoD?

(b) If so, please explain those situations and what options are being examined as possible measures for eliminating them?

(c) If not, what accounts for such subcontractors being told they may not make offers until they become "qualified"?

(d) What is the involvement of competition advocates in bringing an end to these situations?

(e) What contracting mechanism typically is used in making sole-source orders for spare parts as stock items? Does this mechanism afford contracting officers the opportunity, as with negotiated fixed-price contracts, to review subcontract cost or pricing data? Is there a parallel need in procurements of this sort to strengthen safeguard against unreasonable margins of gain by contractors?

A. 15(a) No. We are not aware of any situation where a subcontractor could be excluded from making an offer.

15(b) N /A

15(c) There are no situations where subcontractors can be excluded from making offers.

15(d) The primary role of the competition advocate is to increase the use of competitive procurements. They do this through continued emphasis and review of procurement transactions.

15(e) We use the same contracting mechanisms for making sole-source orders for spare parts as are used in other sole-source procurements. This mechanism affords contracting officers the opportunity to review subcontract cost or pricing data. There is an ongoing effort within the DoD to strengthen our safeguards against unreasonable margins.

Mr. BROOKS. Gentlemen, we appreciate your coming down today and your own contribution to Government efficiency.

How long have you been with the Government, Dr. Wade?

Dr. WADE. Longer than I can remember, sir.

Mr. BROOKS. How about you, Mr. Kendig?

Mr. KENDIG. 28 years, sir.

Mr. BROOKS. A new boy in school.

Dr. WADE. We have a little memory, sir.

Mr. BROOKS. We appreciate your contribution, and as I said earlier, there are a lot of people in Government who could probably make more money working for some contractor, and it's an honorable job. But I think they get more satisfaction out of doing a good job for the Government and make a contribution to it. I think you both are in that category.

It is clear from the testimony today that the Defense Department has yet to get adequate control over all the prices it pays for negotiated contracts and subcontracts. The defense contractors continue to reap windfall profits at the expense of the taxpayer by overpricing, billing unallowable overhead costs, failing to provide Government negotiators with reliable cost data. The practices are apparently pretty widespread and unconscionable.

I expect that the DOD will pursue the overpricing and defective pricing identified in the cases brought before this subcommittee and seek refunds from the contractors involved. There are millions of tax dollars involved in these instances alone.

I would also urge that the Department take prompt action to eliminate the widespread costly misclassification of noncompetitive subcontracts as competitive, to better evaluate the reasonableness of subcontract costs in prime contracts, and to get contractors' cost estimating practices into compliance with the existing laws and regulations that we already have.

Finally, as the witnesses for both the Defense Department and the GAO brought out, changes may well be needed in the Truth in Negotiations Act. This subcommittee will continue to monitor this problem, and when necessary, do its best to insist that needed improvements are made.

The hearing is adjourned. Thank you, gentlemen.

[Whereupon, at 1 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

○